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Too-Big-To-Fail Shareholders

Yesha Yadav

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Article

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Yesha Yadav†

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INTRODUCTION

In June 2017, Spain’s Banco Popular, the country’s fifth largest bank, failed in an orderly fashion—vindicating, it seemed, the rules put in place to manage such insolvencies following the 2008 Financial Crisis.¹ Weighed down by a $100 billion portfolio of bad loans—including toxic mortgages doled out

prior to the 2008 Crisis—Banco Popular was sold off to a competitor for the token sum of one euro and handily wound up without much of an effect on the market.\(^2\) It had lost the confidence of its depositors, who were rushing to withdraw their savings, as well as that of the market, where its share price was plunging.\(^3\) With these rapidly deteriorating prospects, authorities triggered regulatory processes that could take the failing bank and wind it up, preventing the sort of chaos seen in the aftermath of the bankruptcy of Lehman Brothers.\(^4\) Importantly, the losses fell on those who should bear them. Banco’s shareholders and those holding securities designed to convert to equity in a bank collapse, absorbed the cost.\(^5\) With its equity worth just one euro at its wind down, post-Crisis rules seemed to work exactly as planned, ensuring that a major bank’s shareholders bore the costs of its bad behavior and prevented risks from spreading to other firms in the financial system.\(^6\)

But Spain’s banks were not the only ones struggling in the summer of 2017. Italy’s banking crisis that year culminated in the near collapse of the world’s oldest bank and Italy’s fourth largest lender, Monte dei Paschi di Siena.\(^7\) As with Banco Popular, authorities looked to Monte’s shareholders, and those whose accelerating collapse).


3. Bray & Ewing, supra note 2; Morgenson, supra note 1.


6. The wind down of Banco Popular was carried out under the administration of the European Single Resolution Board and the Single Resolution Fund, designed to offer a pan-European mechanism for winding down failing banks. See About SRB, SINGLE RESOL. BOARD, https://srb.europa.eu/en/mission (last visited Oct. 22, 2018). It forms part of the pan-European bank supervisory system under the auspices of the European Central Bank. Id.

bond interests would convert to equity, to bear the brunt of the collapse. On this occasion, however, around half of those holding the convertible junior bonds were everyday mom-and-pop retail investors. Rather than allow losses to fall on this more vulnerable group, the Italian state set aside 1.5 billion euros in taxpayer funds to buy up their claims and to insulate them from the worst of the losses.

These contrasting approaches to large bank failures illustrate the gap between the aspirations of post-Crisis rules—designed to make shareholders absorb the impact of risk-taking—and the muddier reality of implementation. In response to the 2008 Crisis, regulation requires banks to shore up their balance sheets by maintaining a much thicker “rainy day fund,” comprised more fully than in years past of capital raised from equity investors. Buffered by a deeper reserve of equity, banks can operate more safely in good times, as well as access funds to pay off depositors, short-term creditors, and senior creditors in case of failure.


9. See REUTERS, supra note 7; Rachel Sanderson et al., Italy Sets Aside €17bn to Wind Down Failing Lenders, FIN. TIMES (June 25, 2017), https://www.ft.com/content/83ad52a8-59a5-11e7-9bc8-8055f264aa8b.


11. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, §§ 202(a), 206, 124 Stat. 1444, 1459 (2010) (stating shareholders are the last to be paid out and are thus wiped out); see David A. Skeel, Jr., Single Point of Entry and the Bankruptcy Alternative, in ACROSS THE GREAT DIVIDE 311–33 (Martin Neil Baily & John B. Taylor eds., 2014). It should be noted that commentators have remarked on various drawbacks of Dodd-Frank’s Orderly Liquidation Authority (OLA). See THOMAS H. JACKSON ET AL., RESOLUTION OF FAILED FINANCIAL INSTITUTIONS: ORDERLY LIQUIDATION AUTHORITY AND A NEW CHAPTER 14 (2011) (proposing that a new Chapter 14 of the Bankruptcy Code be drawn up to offer an alternative to the involuntary OLA process). These authors also discuss management responses to the incentives set up by the OLA.
In formulating and implementing these rules, however, policymakers have neglected to examine the question of which actors, in fact, constitute the major equity holders of large banks. Scant regulatory attention has been paid to identifying those who take on the residual default risk of a large bank’s failure and thus rank last in line to be paid back in the event the bank heads towards collapse. This inquiry is significant for two reasons. First, knowing which actors are taking on exposure to bank equity offers insight into how effectively they might manage this risk. As with any other company, shareholders possess an array of corporate governance tools to safeguard their exposure by agitating for outcomes regarding how managers run the business. Major bank shareholders, with significant downside exposure, should be well motivated to exercise these tools. Still, if particular bank shareholders are ineffective or unwilling to engage in

Id. at 1–6. See Edward R. Morrison, Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions (Columbia Law & Econ. Working Paper No. 362, 2009), for an early discussion of approaches to resolving large, failing firms and the Bankruptcy Code. On using bankruptcy rules to facilitate the use of single point of entry under the OLA, see Symposium, Implementing Symmetric Treatment of Financial Contracts in Bankruptcy and Bank Resolution, 10 BROOK. J. CORP. FIN. & COM. L. 155 (2015). This article also examines the operation of the exemptions from the automatic stay for derivatives trades. Id. See also JOHN F. BOVENZI ET AL., TOO BIG TO FAIL: THE PATH TO A SOLUTION (2013), for a discussion of ex-post solutions to the too-big-to-fail problem.

12. It should be noted that the Trump administration is pursuing a revision of the reforms undertaken in the wake of the Financial Crisis, including revisions to the OLA, set up to provide for the orderly wind down of large and complex financial institutions. See Ben Proess & Julie Hirschfeld Davis, Trump Moves to Roll Back Obama-Era Financial Regulations, N.Y. TIMES (Feb. 3, 2017), https://www.nytimes.com/2017/02/03/business/dealbook/trump-congress -financial-regulations.html. However, even with attempts to dilute or remove the OLA, proposals offered suggest using the U.S. Bankruptcy Code to wind down complex institutions. See Financial Choice Act, H.R. 10, 115th Cong. (2017); U.S. DEP’T OF THE TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES (2017). Even within a more usual bankruptcy process, shareholders are the last to be paid out and are expected to provide the value needed to pay off creditors higher on the priority ladder. This is reflected in the Absolute Priority Rule in bankruptcy, where shareholders only get paid when all other creditor claims are satisfied. There is enormous literature on the Absolute Priority Rule with discussions and criticisms of its approach. See generally Douglas G. Baird & Donald S. Bernstein, Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain, 115 YALE L.J. 1930 (2006) (examining the viability of the Absolute Priority Rule and the conditions prompting deviations from the Rule); Douglas G. Baird & Robert K. Rasmussen, Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations, 87 VA. L. REV. 921 (2001) (noting the drawbacks of a strict adherence to absolute priority and proposing “relative priority”). See also sources and discussion infra note 40.
bank governance, potentially increasing the likelihood that banks are run riskily, regulators can fill in gaps in oversight and pick up the slack.

Second, understanding who really holds the risk of bank failure can help regulators determine whether these shareholders possess the institutional resilience to absorb the likely losses. Exemplified by the approach taken by Italian authorities towards Monte dei Paschi’s retail investors, regulators may decide that certain investors should not bear these losses as a matter of political economy or financial stability. In such cases, regulators face the prospect of needing to deploy taxpayer funds to bailout bank shareholders, or otherwise to force losses to be borne by another market actor better able to withstand the impact.

This Article fills this gap by identifying the major shareholders of the largest U.S. banks and exploring their effectiveness in overseeing these financial conglomerates. It makes three contributions.

First, this Article identifies major bank shareholders that, as a result of taking on increasing block equity positions since 2011, have come to assume sizable residual default risk on the largest banks in the U.S. financial system. In the years following the enactment of the Dodd-Frank Act, equity ownership of the twenty-six largest and most systemic U.S. banks has come to be focused in the hands of five major shareholders. Surveying

13. See, for example, Cheryl D. Block, Overt and Covert Bailouts: Developing a Public Bailout Policy, 67 IND. L.J. 951 (1992), for a discussion of bailout mechanisms versus the use of the bankruptcy regime. See also Kenneth Ayotte & David A. Skeel, Jr., Bankruptcy or Bailouts? 35 J. CORP. L. 469 (2010) (comparing the advantages of the traditional bankruptcy regime as an alternative to bailouts); Steven M. Davidoff & David Zaring, Regulation by Deal: The Government’s Response to the Financial Crisis, 61 ADMIN. L. REV. 461, 470–75 (2009) (analyzing the response of the U.S. government to the financial crisis and the different techniques utilized by authorities to recapitalize failing institutions); Adam J. Levitin, In Defense of Bailouts, 99 GEO. L.J. 435 (2011) (discussing whether bailouts should be done through Congress or an agency and creditors should be forced to accept partial payments as part of the bailout).

14. In order to determine which banks are the largest and/or most systemic, I examine the list of the U.S. headquartered and regulated banks that were subject to the Federal Reserve’s mandatory stress tests in 2017. The Federal Reserve stress tests subject banks to simulated doomsday scenarios to determine whether they are able to withstand critical shocks. See Bd. of Governors of the Fed. Reserve Sys., Comprehensive Capital Analysis and Review 2016: Assessment Framework and Results (2016). The Federal Reserve focuses on stress testing the most systemically significant banking firms in the United States. Id. Out of the thirty-four banks that the Federal Reserve stress tested in 2017 as part of the Comprehensive Capital Analysis and Review
their 2011 and 2017 annual proxy statements, BlackRock, Fidelity, State Street Global Advisors, T. Rowe Price, and Vanguard, have, during this period, each emerged as holders of multiple block equity ownership stakes (stakes of 5% or more of the bank’s common equity) within the banking system.\(^\text{15}\) Whereas these large banks had zero or just a single equity blockholder listed on their 2011 proxy statements, their 2017 filings showed a marked shift towards at least one if not multiple blockholders at each

(CCAR) program, I do not look at banks whose main base of operations and primary regulators are outside of the United States. On this basis, out of the thirty-four companies subject to Federal Reserve stress tests, I do not look at BancWest Corporation, BBVA Compass Bancshares, BMO Financial Corp., Deutsche Bank Trust Corporation, HSBC North America Holdings, MUFG Americas Holdings, and Santander Holdings USA. I also do not look at TD U.S. Holdings LLC as this company is not publicly traded. On proposed reforms to the stress tests regime, see sources and discussion infra note 40.

15. As Professors Edmans and Holderness note, the definition of what constitutes a blockholder can vary. Alex Edmans & Clifford G. Holderness, Blockholders: Theory and Evidence, in THE HANDBOOK OF THE ECONOMICS OF CORPORATE GOVERNANCE 541 (2017) (discussing blockholding). The 5% threshold—i.e., owning 5% or more of an entity’s stock, such that the holder owns a 5% “block”—is generally useful as it is used by the SEC for reporting purposes, requiring those that achieve this level of ownership to mandatorily report their holdings. See Lucian A. Bebchuk & Robert J. Jackson, Jr., The Law and Economics of Blockholder Disclosure, 2 HARV. BUS. L. REV. 39 (2012) (discussing the disclosure regime and its impact on investor incentives to acquire large holdings).

It should be noted that out of the twenty-six banks that I reviewed subject to the 2017 stress tests, Citizens Financial Group was not included as part of the survey on 2011 ownership as it was then a United Kingdom based bank that was a wholly owned subsidiary of the United Kingdom’s Royal Bank of Scotland. Elizabeth Dexheimer, RBS Raises $2.6 Billion Selling Citizens Financial Shares, BLOOMBERG (Oct. 29, 2015), https://www.bloomberg.com/news/articles/2015-10-29/citizens-says-rbs-is-selling-its-remaining-2.7-billion-stake. Also excluded from the 2011 survey is CIT Group, which filed for Chapter 11 bankruptcy protection in 2009 and only reemerged as a bank in late 2011. Tomoe Murakami Tse, Lender CIT Group Files for Chapter 11 Bankruptcy Protection, WASH. POST (Nov. 2, 2009), http://www.washingtonpost.com/wp-dyn/content/article/2009/11/01/AR2009110101470.html. As such, the 2011 survey looks at twenty-four out of the twenty-six banks on the Federal Reserve’s list. See id.; see also Edmans & Holderness, supra; Halah Touryalai, Back from Bankruptcy: CIT and John Thain’s Stunning Turnaround, FORBES (Aug. 9, 2013), https://www.forbes.com/sites/halahtouryalai/2013/08/09/back-from-bankruptcy-cit-and-john-thains-stunning-turnaround/#58d2a860152b (discussing CIT’s return from its 2009 bankruptcy). It should also be noted that Zions Bank has successfully applied to shed its designation as a systemically important bank. See John Heltman, FSOC Removes Zions’ Systemic Risk Label, AM. BANKER (Sept. 12, 2018), https://www.americanbanker.com/news/fsoc -removes-zions-systemic-risk-label. As such, Zions Bank will be subject to fewer future regulatory investigations (such as likely not being subject to future annual stress tests) to determine its risk to the financial system. See id.
Moreover, with the exception of Fidelity, all of these shareholders increased the number of block positions held between the period of 2011–2017. Whereas Vanguard was a blockholder at just one of the surveyed banks in 2010/11, it had assumed twenty-five positions by 2016/17. Blackrock, a blockholder at ten banks in 2010/11, also ranked as a blockholder at twenty-five firms by 2016/17. State Street, which had one major block stake in 2010/11 had accumulated twelve by 2016/17.

To be sure, it should not be surprising that BlackRock, Fidelity, State Street, T. Rowe Price, and Vanguard, hold significant equity stakes across publicly traded bank holding companies. For one, these investors constitute some of the most prolific shareholders in capital markets, with positions held throughout the population of publicly traded firms. As fund (or asset) managers, directing the pooled wealth of corporate and retail savers into investments, they easily represent the most abundant sources of capital for public companies. BlackRock, for example, boasted nearly $6.3 trillion in assets under management in 2017, Vanguard boasted around $5 trillion as of January 2018, and Fidelity boasted around $2.5 trillion as of March 2018. Positioned to represent this wealth as shareholders of record for the mutual and other funds organized within their organization, BlackRock, Vanguard, and others constitute a powerful and pervasive presence across both Main Street and Wall Street.

16. See tables and discussion infra Part II.B.
17. See tables and discussion infra Part II.B. Fidelity Investments is listed as FMR LLC.
That banks should wish to court this source of funding is understandable, especially when seeking to grow their equity base following the Crisis. But asset managers, too, possess strong incentives to invest in the equity of U.S. banks. Following the Crisis, banks have enjoyed a return to profitability, holding out the promise of dividends and rising share prices. Further, for asset managers tasked with investing in a diversified set of companies, putting capital into bank equity reflects a balanced portfolio, especially at a time of rising bank prospects.

But banks are not ordinary public companies. In its second contribution, this Article assesses the effectiveness of asset managers—firms that specialize in investing cash and other assets on behalf of others—in overseeing bank risk through the levers of corporate governance. In taking on blockholder positions across multiple banks, BlackRock, Vanguard, and others administer funds that stand to suffer potentially significant losses in the event of a large bank failure. From the standpoint of post-Crisis policy, funds invested in bank equity should expect to see the value of these positions reduced to zero in order to help pay off creditors and depositors.

In this context, bank shareholders confront a uniquely complex set of costs in overseeing the largest U.S. banks. For a start, banks are structurally risky. Owing money in the short-term (in the form of deposits) and holding assets in the long-term...


23. See, e.g., John Armour & Jeffrey Gordon, Systemic Harms and Shareholder Value, 6 J. LEGAL ANALYSIS 35 (2014) (observing that the notion of shareholder primacy is much weaker in banking given that adhering to this notion can result in undue risk-taking by bank managers). See generally Christopher M. Bruner, Corporate Governance Reform in Post-Crisis Financial Firms: Two Fundamental Tensions, 60 ARIZ. L. REV. (forthcoming 2018) (observing the significance of corporate governance as a key factor governing financial system risk and highlighting lack of focus by regulators on governance in post-Crisis regulation).
(in the form of loans), their workings are marked by a maturity mismatch that gives rise to the persistent threat of a bank run.\textsuperscript{24} The danger that depositors might rush at once to extract their money, draining banks of cash and triggering fire sales of their assets, introduces systematic instability to bank design and a ready-made challenge for bank governance. In an interconnected financial system, a crisis at one bank can spread to others if depositors scramble to retrieve their money from multiple banks and asset sales depress the value of bank balance sheets across the board.\textsuperscript{25}

The task of overseeing large and complex banks is further complicated by the challenge of interpreting their informational opacity.\textsuperscript{26} Bank assets, in the form of loans, are often difficult and time-consuming to value. The larger banks—with their correspondingly greater number of assets—can place a particularly heavy burden on asset managers seeking to understand the default risk assumed by their funds.\textsuperscript{27} For those firms whose funds are invested in the equity of multiple large banks, these costs will mount and potentially disincentivize investigation and oversight.

Worse still, theory observes that bank shareholders tend also to be uniquely opportunistic and risk seeking. Asset managers, maintaining blockholder positions across several big banks, may (at least according to theory) be especially vulnerable to the pull of this opportunism. Banks benefit from an explicit public subsidy to support their economic functions.\textsuperscript{28} The state guarantees the value of deposits and banks enjoy access to emergency funds from the Federal Reserve.\textsuperscript{29} Furthermore, as made clear in 2008, banks can also be given a taxpayer bailout to cauterize a systemic and economic fallout. In light of this state support, theory recognizes that banks generally enjoy lower funding costs relative to other types of businesses.\textsuperscript{30} The availability of this

\textsuperscript{24} See discussion infra Part I.A.1–2.
\textsuperscript{25} See discussion infra Part I.A.1–2.
\textsuperscript{26} Armour & Gordon, supra note 23; Bruner, supra note 23. See Lev Menand, Article, Too Big to Supervise: The Rise of Financial Conglomerates and the Decline of Discretionary Oversight in Banking, CORNELL L. REV. (forthcoming 2018), for a discussion on the challenges of supervising large banks and the rise of private, compliance-based risk management in bank regulation to contend with the challenge.
\textsuperscript{27} See discussion infra Part I.A.1–2.
\textsuperscript{28} See discussion infra Part I.A.2.
\textsuperscript{29} See discussion infra Part I.A.1–2.
\textsuperscript{30} See discussion infra Part I.A.2.
safety net can motivate bank shareholders to behave in ways that are aggressively risk chasing. Shareholders are driven to push managers towards taking bigger risks promising profits and generous dividends. The risky downside is cushioned by the protection offered by the public safety net. Because of explicit and implicit public assistance, shareholders can underprice risk-taking by banks (relative to how they may price risk at other firms), encouraging them to use governance to push for reckless, rather than risk-mitigating, outcomes. Where shareholders are blockholders at the largest U.S. banks—firms most likely to be offered more open-ended state support in case of crisis—their incentives to subvert governance in favor of risk-taking may be especially strong.

But this Article offers a different account. It posits that asset managers can, in fact, prove a positive in assuring safety and soundness in financial markets regulation. Asset managers like BlackRock or Vanguard are likely to be less incentivized to follow the risk-seeking behaviors of the paradigmatically aggressive bank shareholder. Unlike institutions with their own money on the line and whose managers are paid in accordance with the profits they generate for investors, traditional asset managers follow a different model. They manage other people’s wealth, not their own, and reward managers less through performance-based fees and more through fixed compensation. In seeking to attract everyday retail customers, their services are often marketed as low-cost, constraining the resources available for mounting expensive, activist campaigns. Unsurprisingly, as Professors Gilson and Gordon write, asset managers like BlackRock, Fidelity, or Vanguard, have long been viewed as passive players in corporate governance.

This passive posture towards Main Street governance, though widely criticized, can be beneficial for Wall Street firms.
Asset managers, as blockholders across multiple financial institutions, should lack the requisite incentives to use their powerful, systemic foothold in bank governance for risk chasing at the taxpayers’ expense.

But simply remaining passive is not assurance of good bank oversight. Indeed, if major shareholders leave too much slack, managers can take risks that eventually place bank equity in peril of being used up or devalued to meet the costs of a crisis.

In concluding, this Article’s third contribution lies in proposing pathways to harness the position and incentives of asset managers to create a private, system-wide source of shareholder monitoring of financial markets. In particular, it explores the possibility of tasking top asset managers, holding sizable equity positions, with more active supervision of the banks in which they are invested. From the post-Crisis regulatory standpoint, BlackRock, Fidelity, State Street, T. Rowe Price, and Vanguard, can ill-afford to experience a bad banking crisis. With their funds contributing extensively to the bank equity of the largest financial institutions, the economic costs of a systemic fallout are likely to be especially punishing.

Asset managers have unique advantages in performing oversight. As the biggest shareholders in the marketplace, they are well placed to absorb the high cost of monitoring banks and to use this research to develop systemic insights on account of their repeat blockholdings. With blockholder stakes, their interventions should also carry considerable weight with bank management. Most importantly, asset managers, owing fiduciary duties to fund holders invested across multiple banks, can more fully advocate for the broader interest of safeguarding the financial system.36 Indeed, there are some signs that major asset managers may be willing to take on the costs of more active corporate

36. This proposal may be seen as especially problematic from an antitrust point of view. There is a growing literature around the concept of common ownership of Main Street public companies by the major asset managers. See generally José Azar, Sahil Raina & Martin Schmalz, Ultimate Ownership and Bank Ownership 46, tbl.I (2016) [hereinafter Azar, Ultimate Ownership] (showing the top five shareholders in the six largest American banks in the second quarter of 2013 and the first quarter of 2002); José Azar, Martin C. Schmalz & Isabel Tecu, Anticompetitive Effects of Common Ownership, 73 J. Fin. 1513 (2018) [hereinafter Azar, Anticompetitive Effects] (noting the influence of these investors in potentially incentivizing anticompetitive effects in airline companies); Einer Elhauge, Horizontal Shareholding, 129 Harv. L. Rev. 1267 (2016) (providing an antitrust critique of common ownership, focusing on the airline industry); Eric A. Posner, Fiona M. Scott Morton & E. Glen Weyl, A Proposal to Limit the Anticompetitive Power of Institutional Investors, 81 Antitrust L.J.
governance. In January 2018, for example, with respect to their enormous portfolio of investments, Larry Fink—BlackRock’s CEO—highlighted the firm’s goal of using its position to push for more long-term “investment stewardship” of the public companies where it invests.\(^{37}\)

Importantly, a dialogue between regulators and major bank shareholders can promote a more concrete understanding of who ultimately bears the risk of large bank failures.\(^{38}\) To the extent that this allocation of default risk holds out undesirable policy consequences, as in the case of Monte dei Paschi, regulation is better equipped to respond ex ante, rather than have to manage the messy fallout ex post. As the specter of the 2008 Financial Crisis gradually recedes in time, fueling efforts to deregulate the banking sector, oversight by bank shareholders grows in significance.\(^{39}\) By offering continuing private supervision for banks through changing economic life cycles—as well as being a source

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\(^{669}\) (proposing the challenges of market concentration can be addressed by requiring investors in an oligopolistic industry to choose between limiting their holdings of an industry to a small stake or to hold the shares of a single “effective firm”). Commentators have also critiqued this argument. See Edward B. Rock & Daniel L. Rubinfeld, *Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance* (NYU Law & Econ. Research Paper Series, Working Paper No. 17-05, 2017) (proposing a safe harbor to prevent anticompetitive effects and encourage institutional investors’ involvement in corporate governance); Matt Levine, *Index-Fund Bans and Hedge-Fund Data*, BLOOMBERG (Nov. 22, 2016), https://www.bloomberg.com/view/articles/2016-11-22/index-fund-bans-and-hedge-fund-data (arguing that limiting investors to small stakes or a single effective firm is not plausible because it will cost too much).


\(^{38}\) Further recognizing the importance of corporate governance in bank risk management, the Federal Reserve has turned its attention to clarifying the role of bank boards. Press Release, Fed. Reserve Bd., *Federal Reserve Board Invites Public Comment on Two Proposals; Corporate Governance and Rating System for Large Financial Institutions* (Aug. 3, 2017) (on file with author). The Federal Reserve’s proposal, for example, seeks to encourage boards to clearly outline strategic goals, risk management practices, and accountability measures and to use these as a basis for bank evaluation.

of insight for public regulators—bank equity holders can be strong stewards of banks’ risk management practices.40

This Article proceeds as follows. Part I describes the centrality of equity to the post-Crisis regulatory framework as the critical buffer to safeguard financial markets. Part II explores the role of asset managers in banking and surveys the block ownership at the largest U.S. banks for the years 2011 and 2017. It shows that these banks now include a small number of asset managers as repeat equity blockholders in U.S. banking. Part III builds on this survey to explore the effectiveness of asset managers in bank risk management and governance. Part IV offers a blueprint to more fully co-opt asset managers into bank supervision. Part V concludes.

40. It is important to note that Congressional and administrative efforts are underway to modify and tailor the requirements of the Dodd-Frank Act. See DAVIS POLK, FINANCIAL SERVICES REGULATORY REFORM (2018), https://www.davispolk.com/files/davis_polk_financial_services_regulatory_reform_tool.pdf. While these efforts do not seek to lower the focus on strong buffers of equity as an essential component of safety and soundness regulation, they propose to change how these rules apply to mid-size and smaller banks. See id. In particular, the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) increased the statutory threshold at which the most stringent bank capital and stress testing provisions for banks take effect. Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, § 401, 132 Stat. 1296 (2018) (to be codified at 12 U.S.C. § 5365). Whereas the Dodd-Frank Act mandated that firms with total assets of more than $50 billion be subject to enhanced prudential oversight, the EGRRCPA increased this threshold to $250 billion and gave the Federal Reserve the discretion to apply these standards to banks with between $100 billion and $250 billion in total assets. Id. At the time of this writing, the Federal Reserve has drafted proposed rulemaking that would “significantly” reduce the compliance burden on firms with total assets between $100 billion and $250 billion. Memorandum from Randal Quarles, Vice Chairman for Supervision, Bd. of Governors of the Fed. Reserve Sys., to Board of Governors of the Federal Reserve System 3 (Oct. 24, 2018), https://www.federalreserve.gov/aboutthefed/boardmeetings/files/board-memo -20181031.pdf. Under this rulemaking, firms with assets between $100 billion and $250 billion would no longer be subject to Dodd-Frank’s enhanced liquidity standards to maintain a reserve of highly liquid assets that could be sold off during a panic. Id. at 3, 11. Instead, stress tests for such firms would take place every two years. Id. at 11. This new proposed rulemaking does not seek to alter the application of enhanced prudential rules and stress testing for firms with more than $250 billion in total assets or smaller firms whose profile makes them riskier than their peers. See id. at 2–4. In addition to this draft proposed rulemaking, reform proposes to expand the range of activities that banks can undertake, dismantling Dodd-Frank’s Volcker Rule that restricted the ability of banks to engage in proprietary trading, or trading in securities with their own capital. See generally DAVIS POLK, supra, at 43–44 (providing an overview of current Volcker Rule reform efforts).
I. BANKS, CONTAGION, AND CAPITAL

By design, banks are unique in their capacity to cause widespread economic damage. But they are also essential to a well-functioning economy. Traditionally seen, banks take surplus funds from those who have it (depositors) and loan this money out to those who can use it productively (borrowers). They thus occupy a special place in the economy as providers of a public good. But banks can also fail, causing deep economic harm. They might, for example, make too many bad loans, prompting depositors to extract their savings in panic. If depositors cannot distinguish one failing bank from another, they might withdraw their money from any number of banks. In draining liquidity from the banking system, a bank collapse severely disrupts the flow of capital from savers to borrowers.

The fact of banks being both risky and essential has given rise to an elaborate body of law designed to make them safer and less prone to crises. Central banks offer distressed banks access to emergency loans; depositors are discouraged from panicking by the promise that their money is protected by state guarantee; and regulation requires banks to make sure that they “pay” for

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41. See, e.g., RICKS, supra note 4, at 79–80 (noting the tendency of account holders to redeem when it looks likely that others might do the same).

42. See generally STEPHEN G. CECCHETTI, MONEY, BANKING AND FINANCIAL MARKETS 38–41 (2008) (noting that a salient feature of banking and financial intermediation lies in taking "surplus units" of capital and loaning it to those who have "deficit units" of need for this money); GERALD CORRIGAN, ARE BANKS SPECIAL? A REVISITATION (2000) (noting that banks are "special" because "they offer transaction accounts; . . . they are the backup source of liquidity for all other institutions; and . . . they are the transmission belt for monetary policy"); Pauline Skypala, The Reality Gap in the Role of Banks, FIN. TIMES (June 8, 2015), https://www.ft.com/content/e336ea7e-0d33-11e5-a83a-00144feabd0 (describing the traditional model of banks as intermediaries between savers and borrowers, facilitating credit and money creation). However, this traditional conception of banking is highly simplified, and commentators have identified complexities in this model and described various models of banking. For example, see Zoltan Jakab & Michael Kumhof, Banks Are Not Intermediaries of Loanable Funds—and Why This Matters (Bank of Eng., Working Paper No. 529, 2015). Additionally, commentators note that banks also “create deposits when they make loans . . . effectively expanding the money supply,” Skypala, supra. Professors Omarova and Hockett have also reframed the understanding of banks as intermediaries by focusing on banks as publicly franchised to dispense the full faith and credit of the United States through the financial system. Robert C. Hockett & Saule T. Omarova, The Finance Franchise, 102 CORNELL L. REV. 1143, 1158 (2017). Also, see RICKS, supra note 4, at 79–80, which notes the deposit-issuing function of banks, rather than just functioning as deposit takers.

43. RICKS, supra note 4, at 79–85.
the loans they make by maintaining a reserve of funds—bank capital—that can offer a protective buffer against crises. This Part examines the risks that banks create and how bank capital mitigates them. It highlights the reliance that regulatory policy places on equity as the most desirable type of bank capital. This Part sets the foundation for examining the central inquiry in this Article: with equity so necessary for capital reserves post-Crisis, which investors supply this equity in practice?

A. Why Bank Regulation Needs Equity

The importance of banks for modern economies is matched by the risks they create for markets. Instability lies at the heart of banking.

1. Basics of Bank Function

Banks manage the flow of capital in the economy. They create deposits for those that save money. In modern banking, this arrangement takes the form of an on-demand liability on the bank’s books. A depositor loans its funds to the bank (a liability for the bank) and the bank promises to make these funds immediately available on demand whenever a depositor wants.

Banks also make loans to those needing capital. By smoothing out the capital needs of homes and businesses, banks can encourage a more efficient flow of money. Home buyers do not need to save until such time as they have all the cash they need to buy a property—they can take out a loan instead; businesses do not need to keep large amounts of cash to make payroll—so long as they can generate the cash flows needed in the future to pay off a loan. If a lender believes that its borrowers are sufficiently creditworthy to make payments on loans over a period of time, banks can bridge funding needs and encourage a productive use of capital.

44. For a summary of the regulatory subsidies accorded to banks, see Prasad Krishnamurthy, Regulating Capital, 4 HARV. BUS. L. REV. 1, 22–23 (2014), which details the distortive impact of deposit insurance and lender-of-last-resort funding on the cost of debt funding for banks.

45. Some scholars posit that the fragile capital structure underlying banks is necessary for them to perform their social function of mediating liquidity needs cheaply because if investors (depositors) always needed to have direct assurance from borrowers that they could immediately access cash, they would demand tough control rights from a borrower, which would be socially costly and may not be optimal from the point of view of governance. Douglas W. Diamond & Raghuram G. Rajan, Liquidity Risk, Liquidity Creation and Financial Fragility: A Theory of Banking, 109 J. POL’Y ECON. 287, 287–88 (2001). Diamond
The interaction between the deposit-taking and loan-making functions of banks is complex from the standpoint of banking theory. Conventionally, scholars posit a “linear” relationship between the amount of deposits held by a bank and the loans that the bank makes; in other words, banks use whatever depositor capital they have to lend, such that they are always “intermediating” capital flows.\(^46\)

This intermediation model is more complex than first meets the eye. As Professors Jakab and Kumhof observe, banks also create deposits when they lend money to a borrower.\(^47\) When a bank makes a loan to a borrower, it opens an account and deposits the funds in this account for the borrower’s use.\(^48\) Banks do not, therefore, debit money from a depositor’s account and credit it to the account of the borrower. Rather, banks create money by depositing loan funds in a new account.\(^49\) These funds are thus additional to those also available to the depositor. In issuing a new loan, a bank acquires an asset on its balance sheet because it is entitled to eventually be repaid on the loan by the borrower.\(^50\)

In this way, banks can expansively create assets and liabilities on their balance sheets. They do not need to show a direct debit from a saver to a credit on the borrower’s books. Instead, banks simply generate a new deposit entry on their ledger and

and Rajan also note that the goal of mediating liquidity needs between depositors and borrowers over time helps explain why these two functions are combined in the institution of a bank. Id. at 320.


\(^47\) Jakab & Kumhof, supra note 42, at 6–7.

\(^48\) Id.

\(^49\) Id.

\(^50\) See Charles Goodhart, Whatever Became of the Monetary Aggregates?, Speech at the Peston Lecture in Honor of Maurice, Lord Peston (Feb. 28, 2007), in LSE Fin. Mkts. Group Paper Series, Feb. 2007, at 13 (noting the traditional reliance on the theory of banks as intermediates of capital and suggesting a better model as one where banks create money through lending and the creation of deposits); see also Hockett & Omarova, supra note 42 (pointing to the “franchise” model where banks are franchised to distribute financing ultimately backstopped by the State).
add a corresponding asset to reflect a new source of revenue. As Jakab, Kumhof, and Pozsar note, without some positive constraint from regulation or the market placing a cost on their abilities to create liabilities and new assets, banks can run up enormous balance sheets in financial markets.51

_Provision of Financial Services:_ The place of banks at the center of deposit-taking and lending activity—with the informational advantages it provides—has supported an expansion in the financial services that banks offer.52 Beyond just taking deposits and providing loans, banks can harness their expertise and access to cheap funding (e.g., through deposits) to provide a range of financial services to a broad variety of clients.

The “universal” banking model—where banks provide a spectrum of financial services—has become the norm in the United States and in Europe.53 Through networks of subsidiaries, affiliates, and branches, banking groups routinely include


53. See generally Saule T. Omarova, _The Merchants of Wall Street: Banking, Commerce, and Commodities_, 98 _Minn. L. Rev._ 265 (2013) [hereinafter Omarova, Merchants] (discussing the role of commercial banks in commodities trading and warehousing); Asli Demirgüç-Kunt & Harry Huizinga, _Bank Activity and Funding Strategies: The Impact on Risk and Returns_ 2–4 (The World Bank Dev. Research Grp., Working Paper No. 4873, 2009) (noting the expansion of services that United States and European banks have provided since the 2008 Financial Crisis). In the United States, under the Bank Holding Company Act of 1956, the commercial banking and investment banking operations of finance were kept separate, with bank holding companies restricted to performing activities that were within the ambit of the “business of banking,” Pub. L. No. 84–511, § 4, 70 Stat. 133, 135–37 (1956) (codified at 12 U.S.C. §§ 1841–43 (2012)). However, owing to an incremental set of changes and finally the Gramm-Leach-
providers of financial advice, trading services in securities markets, securities underwriting, insurance, payments (e.g., issuing credit cards), lending to other financial firms, and so on. Banking firms can also trade for themselves, putting their own capital on the line to invest in markets. A full analysis of the broad services portfolio of modern banking groups is outside the scope of this Article. However, it is worth underlining that banks have dramatically expanded their offerings far beyond the basic model of financial intermediation that undergirds their core function.

Banks have been particularly adept at broadening their scope of activities. They can access credit relatively cheaply, for example, through deposit funds or through their ability to borrow from other financial firms. They enjoy access to emergency funds from the Federal Reserve and protection for retail deposits through deposit insurance. Scholars have observed that larger banks generally benefit from lower funding costs because of an implicit expectation that regulators will not let such big banks


55. See Demirgüç-Kunt & Huizinga, supra note 53.

56. See generally id. at 2–6 (investigating the impact of diversified banking approaches and how deposit, nondeposit, and wholesale funding from other financial firms impacts a bank’s risk-return profile).

57. Id.

58. Id.
collapse and renege on their debts. With this ready access to funds and the provision of a federal safety net, banks can offer financial services at lower costs to themselves than a nonbank. If banks can privately access cheap finance and use this money to sell services at a higher price, they can turn a profit. The cheaper their own funding costs, the better banks compete on the range of services and products that they might be able to offer.

Whether banks should be involved so extensively in financial services is a controversial question. This Article does not enter into this debate. Rather, it points to economic conditions—such as cheaper financing and access to information—that have

59. The literature in this area is extensive. See, e.g., Asli Demirgüç-Kunt & Harry Huizinga, Are Banks Too Big To Fail or Too Big To Save? International Evidence from Equity Prices and CDS Spreads, 37 J. BANKING & FIN. 875 (2013) (showing that CDS spreads are lower for larger banks); Andrew G. Haldane, The $100 Billion Question, BANK FOR INT’L SETTLEMENTS Q. REV. 1, 3 (Mar. 2010), http://www.bis.org/review/r100406d.pdf (noting that banks appear to show differences in “support ratings” or the perception that banks are likely to receive state support on account of size and market share); João A.C. Santos, Evidence from the Bond Market on Banks’ “Too-Big-to-Fail” Subsidy, 20 FED. RES. BANK N.Y. ECON. POLY REV. 29 (2014) (noting that between 1985 and 2009, bond spreads appeared to be smaller for larger banks, suggesting that larger banks can often see a much lower cost of funding versus smaller banks and nonbank firms). But see U.S. GOV’T ACCOUNTABILITY OFFICE, LARGE BANK HOLDING COMPANIES: EXPECTATIONS OF GOVERNMENT SUPPORT 11–15 (2014) (noting that the extent of the funding advantage for larger firms may be growing smaller).

60. But see AZAR, ULTIMATE OWNERSHIP, supra note 36 (noting that common ownership is encouraging anticompetitive behavior by banks in offering more expensive products to customers). However, cheaper funding costs for banks can enable them to theoretically use this funding to offer a range of financial services, though anticompetitive behavior may encourage banks to seek out oligopolistic rents.

61. Numerous scholars have given historical overviews, cross-country comparisons, and outlines of the key policy trade-offs of applying the universal banking model to U.S. banks. See, e.g., RICARDO T. FERNHOLZ & CHRISTOFFER KOCH, WHY ARE BIG BANKS GETTING BIGGER? 8, 25 (2016) (noting that expansion of banking services into the nonbanking area has helped reduce idiosyncratic volatilities in particular asset groups); Adam J. Levitin, Safe Banking: Finance and Democracy, 83 U. CHI. L. REV. 357, 412 (2016) (advocating for narrow banking, where banks take deposits and invest this cash in safe assets); Omarova, Unfulfilled Promise, supra note 53, at 1775 (contrasting the historical Glass-Steagall principle of organizational separation with universal banking); Bernard Shull, The Separation of Banking and Commerce in the United States: An Examination of Principal Issues, 8 FIN. MARKETS INSTITUTES & INSTRUMENTS 1, 9–12 (1999) (showing that the separation between banking and commerce had been eroding throughout the 1970s and 1980s); Demirgüç-Kunt & Huizinga, supra note 53, at 2–6 (noting the costs and benefits of universal banking and the advantages of diversification versus the risks).
made it possible for banking firms to adopt a universal model.\textsuperscript{62} Over the last two decades, commercial banks have moved well beyond basic deposit-taking and lending to offer a range of services.\textsuperscript{63} The 2008 Financial Crisis also saw the big investment banks, Lehman Brothers, Goldman Sachs, Merrill Lynch, Morgan Stanley, and Bear Stearns collapse, become commercial banks, or join existing banking groups.\textsuperscript{64} As a result, the United States is home to some of the largest global banking groups, including Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo, that specialize in offering a range of services of which deposit taking and lending constitute just one (usually less profitable)\textsuperscript{65} part. For example, in the third quarter of 2016, major U.S. banking groups saw dramatic revenue gains, not always owing to the usual banking functions, but to their role as dealers in global securities markets.\textsuperscript{66} In the case of J.P. Morgan, for example, its community and consumerbanking unit saw profits

\textsuperscript{62} Demirgüç-Kunt & Huizinga, supra note 53.

\textsuperscript{63} See generally Omarova, Unfulfilled Promise, supra note 53 (discussing the history of the expansion in the range of services offered by banks).


\textsuperscript{65} See, e.g., Beverly J. Hirtle & Kevin J. Stiroh, The Return to Retail and the Performance of U.S. Banks, 31 J. BANKING & FIN. 1101, 1101–02, 1116–17 (2007) (highlighting large U.S. banks and noting that retail banking operations are usually less volatile but less profitable for banks).

\textsuperscript{66} Dakin Campbell, Goldman Sachs Bond-Trading Engine Revs Up To Beat Estimates, BLOOMBERG L., Oct. 18, 2016 (noting a 49% increase in Goldman Sachs’s 2016 third quarter revenue in large part because of its rebound in bond trading); Hugh Son, JPMorgan Earnings Beat Estimates on Bond-Trading Revenue, BLOOMBERG L., Oct. 14, 2016; Olivia Oran & Sweta Singh, Morgan Stanley Profit Jumps on Bond-Trading Comeback, REUTERS (Oct. 19, 2016), http://www.reuters.com/article/us-morgan-stanley-results-idUSKCN12J16C (noting that Morgan Stanley’s bond-trading revenue more than doubled in the 2016 third quarter). It should be noted that Goldman Sachs, traditionally an investment bank without commercial banking operations before 2008, recently opened an online retail banking and lending operation. For further discussion, see Martin Neil Baily et al., The Big Four Banks: The Evolution of the Financial Sector, BROOKINGS INST., May 26, 2015. Put briefly, dealers help keep the market running smoothly by mediating trades between buyers and sellers as well as standing ready to buy and sell securities with their own money to keep the markets trading smoothly. This function ensures that markets have liquidity and do not suffer from sudden, abnormal price spikes when there is a rush or large demand for securities. For a discussion of dealer operations, see Yesha Yadav, Insider Trading and Market Structure, 63 UCLA L. REV. 968, 981–88 (2016).
fall by 16%, with provisions made for credit losses of $1.29 billion, up from $389 million in 2015. By contrast, revenue from its securities trading services rose by 33% from the previous year, with revenues from bond trading growing at an astonishing 48% from 2015.

2. The Problem of Banking Design

Instability is a feature of the banking system. Banks mediate temporal fluctuations in demand for and supply of cash. Depositors must get their money on demand; borrowers need to lock in money for long-term projects. The need to manage these dual tasks—to deliver depositor money on demand and to also finance longer-term loans to borrowers—creates a fundamental instability in banking. If depositors all need their money back at once, then banks cannot continue lending. And because they have to immediately pay depositors back, banks may have to call in the loans they have made. This instability thus reflects two key features of a bank’s function: (1) a temporal mismatch in issuing demand deposits and investing in longer-term borrower debt; and (2) the potential for sudden depositor demand for a return of their cash.

Banking scholars have devoted extensive study to this instability. Professors Diamond and Dybvig point to panic as the major challenge of predicting bank runs and their seriousness. Depositors do not know if they are going to get their money back if a bank looks like it is in trouble. Those who are first in line will be paid, and those who are slower may face uncertainties as to whether their money is safe. This dynamic can prompt depositors to engage in anticipatory withdrawals simply to beat other depositors to the exit at the smallest sign of trouble. Depositors can be impervious to information in these circumstances. Even if information exists to correct a misperception of risk, depositors might still wish to get their money out. Worse, depositors might

67. Son, supra note 66.
69. Diamond & Rajan, supra note 45.
70. Id. at 325.
72. Diamond & Dybvig, supra note 71, at 401–03.
well conflate problems at one bank as affecting every bank and rush to claim their money across firms. Such systemic disorder creates enormous costs for the market—too big for any single firm to control and too large to contain without calling in loans and selling assets at distressed prices.\textsuperscript{73}

Regulators have controlled these doomsday scenarios by providing insurance to customers to protect deposits (up to two hundred and fifty thousand dollars per account) and by giving banks access to emergency funding from the Federal Reserve.\textsuperscript{74} Also, the fact that banks are large and diversified might be seen as providing protection against a collapse caused by large-scale depositor flight. If banks are able to derive revenue from multiple business lines, then depositors may be less anxious if one or another were to fail: other sources of revenue could perhaps cushion the blow.\textsuperscript{75} Because of the potential for contagion, troubles at one bank might signal trouble at other banks. In other industries (e.g., aviation),\textsuperscript{76} a competitor’s collapse should be a source of gain for those that remain. In banking, by contrast, the

\begin{footnotesize}
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\item[73.] Id. at 409–10.
\item[74.] The Federal Deposit Insurance Corporation (FDIC) provides deposit insurance to protect two hundred and fifty thousand dollars per customer and account. \textit{How Are My Deposit Accounts Insured by the FDIC?}, FED. DEPOSIT INS. CORP., https://www.fdic.gov/deposit/covered/categories.html (last updated Jan. 31, 2018). It has been widely noted that this safety net has prevented runs successfully in U.S. banking markets. See, e.g., Discount Window Lending, BOARD GOVERNORS FED. RES. SYS., https://www.federalreserve.gov/regreform/discount-window.htm (last updated June 29, 2018).
\item[75.] I do not delve here into risks pertaining to the shadow banking system, where firms issue short-term deposits to other financial firms and then use these funds to invest in longer-term facilities—creating the kind of temporal mismatch seen in everyday retail banking. For a persuasive and insightful account of the risks of such money-like arrangements, see RICKS, supra note 4, at 10–11. For a discussion of shadow banking, see GARY GORTON, SLAPPED IN THE FACE BY THE INVISIBLE HAND: BANKING AND THE PANIC OF 2007 at 2–4 (2009), and ZOLTAN POZSAR ET AL., SHADOW BANKING (2012). On the repo market, see VIKTORIA BAKLANOVA ET AL., REFERENCE GUIDE TO THE U.S. REPO AND SECURITIES LENDING MARKETS (2015), which describes the function of the repo market and maturity transformation. On runs in the repo market, see Gary Gorton & Andrew Metrick, Securitized Banking and the Run on the Repo, 104 J. FIN. ECON. 425 (2012), and Mannohan Singh & James Aitken, The (Sizable) Role of Rehypothecation in the Shadow Banking System (Int’l Monetary Fund, Working Paper No. 10/172, 2010).
\item[76.] See, e.g., Natalia Wojcik, Shares of United Fall for Second Day as Controversy Lingers, CNBC (Apr. 12, 2017), https://www.cnbc.com/2017/04/12/shares-of-united-fall-for-second-day-as-controversy-lingers.html (noting that “[o]ther airlines saw a boost in their share prices” after a video went viral of a man being dragged off an overbooked United flight).
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collapse of a major bank may well also push its competitors into distress, provoking a broader system-wide crisis.\textsuperscript{77}

\section*{B. Banks and Capital Regulation}

Bank regulation confronts several problems. First, major banks mediate an array of economic relationships. Second, reflecting this significance, regulation offers banks a safety net in the form of deposit insurance and access to emergency Federal Reserve funding. Firms can also receive ad hoc implicit support in the form of a bailout.\textsuperscript{78} Because of their economic stature, large banks can enjoy reduced funding costs, such that further growth may be more easily fueled by low-cost borrowing. Ultimately, these dynamics create a set of well-recognized bad incentives. An explicit or implicit safety net can motivate risk-taking by a bank, incentivizing reckless lending or expansion into profitable but problematic areas of the market.\textsuperscript{79} Creditors too may be encouraged to lend more freely to a large bank, knowing they will be paid off by regulators in a bailout.\textsuperscript{80}

\subsection*{1. The Rationale for Capital Regulation}

Regulatory policy has responded to these tensions, in crucial part, by regulating how individual banks design their capital structure relative to the risks they take on.\textsuperscript{81} Regulation seeks to control how banks fund themselves. How much banks borrow, what kinds of securities they invest in, how much unencumbered cash they have, and their reliance on equity capital are, in large

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\item[(78).] RICKS, supra note 4, at 95, 186.
\item[(79).] Diamond & Dybvig, supra note 71, at 416–17.
\item[(80).] LeVitin, supra note 13, at 486.
\item[(81).] Shull, supra note 61 (discussing historical attempts to regulate banking through structural restrictions and as well as geographical restrictions on banking activity). Clearly, capital regulation is a central but by no means the only policy tool available to regulators. For example, bank regulation may target what kinds of activities a bank is qualified to perform. Activity-based restrictions underpin proposals to return banks to narrow banking or to Glass-Steagall Act-type restrictions that policed the separation between banking and commercial activity. See LeVitin, supra note 61 (justifying a narrow banking approach); Omarova, \textit{Merchants}, supra note 53, at 279–80 (tracing the erosion of the Glass-Steagall Act and the role of banks in commodity markets). Additionally, regulators might tailor how they supervise banks to better control the risks that banks take on, such as through more consolidation supervision for larger banks. For discussion, see Krishnamurthy, supra note 44, at 3–4 (noting supervision by the Financial Stability Oversight Council as a regulatory tool).
\end{itemize}
part, a matter of public policy, not private decision making. The mix of debt-cash-equity in any bank’s capital structure is subject to careful regulation to determine whether it helps a bank withstand shocks and prevent bank failure. Capital regulation thus constitutes a touchstone in financial regulation. Indeed, as Professor Tarullo has written, regulating whether a bank’s capital structure is adequate to the risks it assumes has come to be “the most important type of regulation” for maintaining financial system safety.

Banks have an especially unusual capital structure by the fact of how they function. Bank deposits constitute loans to a bank that must be repayable on demand. Because a key source of bank funds represents an on-demand loan to the bank, a bank’s capital structure is naturally leveraged. Unlike a normal company that might be entirely funded by its shareholders, banks are creatures of debt as a constituting part of their capital structure. The risk of this debt is controlled, in part, by the availability of deposit insurance and emergency funds.

Counterintuitively, banks make money from the debt they extend to others (e.g., the loans they make to borrowers). These assets generate profits through interest repayments and fees. They can also generate losses. If a bank makes overly-risky loans, then borrowers may not repay. If these losses look like

83. DANIEL K. TARULLO, BANKING ON BASEL 15 (2008) (“[C]apital adequacy requirements have become the most important type of regulation designed to protect bank safety and soundness.”).
84. The axiomatic Modigliani-Miller Theorem in corporate finance states that the mix of debt and equity within a firm does not affect the firm’s fundamental value. Franco Modigliani & Merton H. Miller, The Cost of Capital, Corporation Finance and the Theory of Investment, 48 AM. ECON. REV. 261 (1958). In the absence of transaction costs like taxation, legal enforceability, and so on, whether a company finances itself using debt or equity should not impact its value. Scholars have long debated whether the Modigliani-Miller Theorem applies in the case of banking firms. See, e.g., Sofiane Aboura & Emmanuel Lepinette, Do Banks Satisfy the Modigliani-Miller Theorem?, 35 ECON. BULL. 924 (2015) (arguing the Modigliani-Miller Theorem does not apply to banks). Bluntly put, if it does apply, then increasing bank equity should come at little cost to overall bank profitability. Conversely, if it does not apply, there is an argument for thinking about these varying costs in determining regulatory requirements for bank capital. This Article does not get into the debate of whether the Modigliani-Miller Theorem should apply to banks or what the optimal mix of debt and equity should be for capital regulation.
85. See Krishnamurthy, supra note 44, at 3–5 (explaining supervision by the Financial Stability Oversight Council).
they might imperil the bank’s future, then depositors will move quickly to recover their deposits and cause the bank to fail.86

Capital buffers provide protection against the instability of a bank’s capital structure and the chance that a run might cause insolvency.87 As Professor Tarullo notes, capital buffers offer protection against the rapid insolvency of a bank on account of expected losses caused by bad loans.88 They also provide comfort to those that lend money to banks and that can feel confident about repayment. A reserve of capital should thus help reduce the costs that banks pay to borrow money.89

The difficulty lies in calculating how much capital a bank should keep and what assets should count as capital for the sake of the safety buffer. If banks must set aside capital as part of their activities, they internalize a compliance cost as part of their business. If a bank perceives these costs as being too high, it might lend less or sell off existing loans to reduce the risks on its books. Reduced lending or a sell-off of loans might dampen the flow of credit and hurt economic activity. Conversely, if the buffer only includes low-quality assets (like junk bonds or volatile currencies) then the safety it offers is illusory. In such cases, the costs that a bank does internalize are insufficient to reflect the risks it takes. A bad capital buffer can transfer the risks of a dangerous bank onto the public purse (that must pay depositors through insurance) as well as to the bank’s creditors who are not repaid on what they are owed.

2. Equity Funding in Capital Regulation

Global regulators have generally agreed on common standards for how much capital international banks must keep and what kind of capital ought to be included within the buffer.90 Since the late 1980s, policymakers have developed and implemented a series of Basel Capital Accords that establish the method by which capital must be calculated and the amount and composition of the capital buffer.91 Most recently, this effort has

86. King, supra note 77, at 59.
87. TARULLO, supra note 83, at 16–18.
88. Id.
89. Id.
91. TARULLO, supra note 83, at 2–44 (providing a history of the Basel rule-making process and the rationales driving the creation of Basel I and Basel II Capital Accords and the benefits and drawbacks of the Basel approach); see also
culminated in the Basel III Accord, formulated as part of post-Crisis reform and implemented into U.S. law through the Dodd-Frank Act and the Federal Reserve’s piecemeal rulemaking. Scholars have written extensively about the Basel Accords and their effectiveness. This Article does not revisit these debates. Rather, it identifies a marked shift in international capital regulation towards greater reliance on common equity as an essential part of the capital buffer. This focus on common equity capital aligns with concurrent efforts by regulators to ensure that banks are structured to be wound down without cost to the financial system. As equity buffers grow thicker, their protective cushion should absorb losses and ensure that creditors have value from which they will get repaid.

Calculating Capital: Somewhat counterintuitively, regulators do not look to a bank’s liabilities (i.e. deposits) when working out how much capital it should keep—these are underwritten by the public safety net. Rather, they look to a bank’s assets—the loans that the bank makes. These represent the source of a


93. See TARULLO, supra note 83, at 7–13 (discussing the effectiveness of Basel I and II); see also HEIDI MANADANIS SCHOOENER & MICHAEL W. TAYLOR, GLOBAL BANK REGULATION: PRINCIPLES AND POLICIES 137–81 (2010).

94. See TARULLO, supra note 83, at 17–19 (discussing broadly the role of bank equity in controlling bank risk-taking and absorbing losses); see also Douglas J. Elliot, Higher Bank Capital Requirements Would Come at a Price, BROOKINGS (Feb. 20, 2013), https://www.brookings.edu/research/higher-bank-capital-requirements-would-come-at-a-price (noting the broad theoretical arguments for and against common equity and bank safety and soundness).

95. This was not always the case. From the 1900s through the 1930s, regulators examined the capital-deposit ratio. TARULLO, supra note 83, at 29–30; see also TAIR E. ORGELER & BENJAMIN WOLKOWITZ, BANK CAPITAL 8–29 (1976) (providing insights into the definition and functions of capital).

96. See TARULLO, supra note 83, at 29 (comparing current practice with earlier practice).
bank’s profits but also the source of risk as bad lending decisions can push a bank towards default.97

International regulators have broadly agreed on how to work out the riskiness of bank assets and the capital that banks need to keep.98 To quantify the riskiness of assets, regulation assigns “a risk rating” to different types of loans.99 A loan to a developed country should be much less risky than a loan to a start-up company and credit to a top-rated company less risky than credit to a poorly performing one.100 The amount of capital that a bank should keep can be determined by reference to this risk rating and risk weighting. For example, a one hundred thousand dollar loan to a top-rated company might be rated at a risk rate of 20%. Applying the 20% risk rating, the loan might be seen as having a notional risk weighted value of twenty thousand dollars—it’s “riskiness.” The amount of capital that a bank sets aside can be determined as a percentage of the riskiness on the bank’s balance sheet.

In the case of both Basel I and Basel II, regulators asked that banks set aside capital equal to 8% of all risk-weighted assets on their books.101 And of this 8%, 4% was required to be comprised of so-called Tier 1 (that is, the safest) capital—fully paid up common equity and disclosed reserves.102 The rest could be made of Tier 2 capital—a wider category of capital that included less safe but viable types of assets like undisclosed reserves.103

97. See id. at 17–19.
98. See id. at 55–56 (discussing the agreements at the heart of Basel I and II); see also BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT’L SETTLEMENTS, BASEL III: FINALIZING POST-CRISIS REFORMS (2017), https://www.bis.org/bcbs/publ/d424.pdf.
100. This methodology largely reflects the blunt Basel I and Basel II foundational Internal Ratings-Based approaches, which were fairly crude in establishing riskiness for different borrowers depending on the type of borrower (Basel I) or a borrower’s credit rating (Basel II). See TARULLO, supra note 83, at 55–56. In reality, larger banks use the Advanced Internal Ratings-Based Approach, where calculating riskiness is determined by sophisticated models of default risk. See generally BASEL COMM. ON BANKING SUPERVISION, THE INTERNAL RATINGS-BASED APPROACH (2001), https://www.bis.org/publ/bcbsca05.pdf (describing the Internal Ratings-Based Approach as implemented by large banks). The example, above, is therefore highly simplified and unlikely to reflect the approach of large banks. Professor Tarullo provides a discussion of this approach and methodology. See TARULLO, supra note 83, 55–60.
102. TARULLO, supra note 83, at 55–60.
103. Id.
Taking the above example, the one hundred thousand dollar loan, risk-weighted at twenty thousand dollars, would need a bank to keep one thousand six hundred dollars in capital of which eight hundred dollars must be in the form of fully paid up equity or disclosed reserves.

The first two iterations of the Basel Accords have come in for strident critique—not surprising given their failure to prevent the Crisis.\textsuperscript{104} Pre-Crisis capital buffers proved woefully insufficient.\textsuperscript{105} As Professor Acharya observes, the six U.S. firms suffering the largest write-downs of their assets saw around $696 billion worth of losses between March 2007 and June 2010.\textsuperscript{106} Between June 2007 and December 2008, the market value of these six firms was down, on average, by 88% and they veered towards a close or near total collapse, with greater liabilities than equity could support.\textsuperscript{107}

Post-Crisis financial regulation has turned to equity funding as the solution.\textsuperscript{108} Post-Crisis, scholars and policymakers have advocated for thicker capital buffers that are more fully funded by common equity.\textsuperscript{109} In influential writings, Professors Admati,
DeMarzo, Hellwig, and Pfleiderer have argued for deep equity cushions.\textsuperscript{110} They point to past eras of banking when equity routinely funded 40\%–50\% of bank business.\textsuperscript{111} While the authors stop short of proposing hard benchmarks, they clearly consider modern-day levels of shareholder equity as falling woefully short.\textsuperscript{112} They are not alone. Professors Hanson, Kashyap, and Stein, for example, propose the creation of plentiful counter-cyclical capital buffers that banks build up in good times to maintain their businesses during downturns.\textsuperscript{113} They, too, highlight the significance of good quality capital, singling out common equity as a major protection against future crisis.\textsuperscript{114} Common equity—rather than preferred stock or even long-term debt—is viewed as giving banks the best chance of surviving a fallout.\textsuperscript{115} The funds raised are readily available, without any commitment to set aside cash for creditors or preferred shareholders.\textsuperscript{116} This buffer—rather than being expensive—can reduce a bank’s riskiness and funding costs.\textsuperscript{117} A reserve of equity can also reassure a bank’s funding providers and help to lower its credit risk and borrowing costs.\textsuperscript{118}

\textsuperscript{110}. Admati et al., \textit{Fallacies}, supra note 109.
\textsuperscript{111}. Id.; see also ADMATI, BANKERS’ NEW CLOTHES, supra note 109.
\textsuperscript{112}. Id.; see also Admati et al., \textit{Fallacies}, supra note 109; see also ADMATI, BANKERS’ NEW CLOTHES, supra note 109.
\textsuperscript{114}. Id.; see also Oliver Hart & Luigi Zingales, \textit{A New Capital Regulation for Large Financial Institutions}, 13 AM. L. & ECON. REV. 453, 456 (2011) (proposing a new methodology for calculating bank capital that requires banks to maintain equity and long-term debt levels at a high enough level that the credit default swap (CDS) prices on junior long-term bank debt stays above a preset level, with the possibility that banks must issue new equity to reflect the added risk if the CDS prices rise). There remain criticisms of the view that higher capital requirements are necessarily the answer to solve banking crisis. For example, commentators note that the proposals do not fully account for the potential reduction in lending that may follow and a lack of clarity with respect to the objective of bank regulation—saving banks from a crisis or ensuring they are positioned to continue working and lending. See Krishnamurthy, supra note 44, at 4–6; see also Hal S. Scott, \textit{Reducing Systemic Risk Through Reform of Capital Regulation}, 13 J. INT’L ECON. L. 763, 767 (2010).
\textsuperscript{115}. Hanson, Kashyap & Stein, supra note 113, at 7–9.
\textsuperscript{116}. Id. at 9.
\textsuperscript{117}. Id.; see also Admati et al., \textit{Leverage}, supra note 109, at 145–46.
\textsuperscript{118}. Id.; see also Admati et al., \textit{Fallacies}, supra note 109, at 13–19; see Hanson, Kashyap & Stein, supra note 113, at 17–21 (noting that the impact of higher equity is...
Basel III increases the required level of common equity from pre-Crisis levels, with extra equity safety buffers and countercyclical capital charges mandated for the largest, most systemically significant global banks.\textsuperscript{110} Basel III introduces a new category of gold-plated capital—the Common Equity Tier 1 (or CET1) that focuses only on the value of common equity, the share premium attached to equity as well as retained earnings.\textsuperscript{120} Preferred stock is not included within this calculation.\textsuperscript{121} In addition to formalizing common equity as the top-tier capital type, Basel III requires an increase in the Tier 1 and CET1 buffers for banks.\textsuperscript{122} Rather than keep to a thin 4% Tier 1 buffer, Basel III requires that common equity (CET1) alone fund a minimum reserve of 4.5% of risk-weighted assets (RWA) and a capital conservation buffer of 2.5%.\textsuperscript{123} Large global banks may also be asked to hold 0%–0.25% CET1 as part of a countercyclical capital buffer and another 0%–2.5% CET1 as a charge to account for the risk created by their size and stature.\textsuperscript{124} When finally implemented, Basel III should thus cause the largest banking firms to maintain a minimum of 12% of risk-weighted capital in the form of common equity.\textsuperscript{125} On top of this, Basel III expects banks to keep at least 1.5% of RWA in the form of general Tier 1 assets and a further 2% in the form of Tier 2 assets.\textsuperscript{126}

Notably, the Federal Reserve mandates higher-than-Basel CET1 charges for eight U.S. banking groups designated as being systemically important for global markets (a G-SIB charge).\textsuperscript{127}
Rather than charge its banks the Basel III-maximum of 2.5% CET1 for being large and important, the Federal Reserve’s rule permits a higher maximum of between 1%–4.5% CET1 capital for its largest and most impactful constituents. Of the eight designated U.S. banks, JPMorgan Chase is set to eventually incur the maximum 4.5% CET1 G-SIB charge with others paying incrementally lower charges depending on their size and profile. In preparation for this ramping-up of demand for equity, major U.S. banking groups are well on their way to raising the equity necessary to support their business.

Post-Crisis reform also relies on capital buffers to allow for the orderly resolution of failing firms. Under the Dodd-Frank Act’s Orderly Liquidation Authority (OLA), a center-piece of post-2008 regulatory architecture, thick equity capital buffers are essential. Under the OLA, equity reserves absorb bank losses and fund the wind down of a failing bank, until such time as its assets can be sold and restructured. This means that equity is used to pay off creditors and depositors. To the extent that any value remains in the equity of a bank holding company after paying off obligations, it will be used by regulators to fund the reorganized bank. Put simply, common equity faces an ex-


128. DAVISPOLK, supra note 119, at 21.


130. Id.


133. 12 U.S.C. §§ 5384(a), 5386(5), 5392(a), 5392(c) (“[C]reditors and share-holders will bear the losses of the covered financial company.”).

134. Id. §§ 5386, 5390(b).

135. Id. § 5390(b).
tinction event if the OLA is invoked to wind down a large financial institution.\textsuperscript{136}

In sum, common equity constitutes a foundation on which safer, more resilient financial institutions are grounded post-Crisis. Under Basel III and the Dodd-Frank Act, common equity constitutes the essential pillar supporting an orderly wind down of a complex financial institution. Indeed, for a cohort of influential scholars and policymakers, the problem with today’s financial system lies not in the fact of this reliance, but rather in its lack of ambition.\textsuperscript{137} In other words, existing demands for equity in financial regulation do not go far enough—and banks should raise a bigger capital buffer comprised more heavily of funding from common equity.

\textbf{II. ASSET MANAGERS AS BANK EQUITY SUPPLIERS}

With increased demands for common equity, capital markets have assumed enormous significance in supplying the resources needed to keep financial markets protected.\textsuperscript{138} Despite this importance, however, surprisingly little attention has gone into constructing a picture of which investors supply this capital in practice.\textsuperscript{139} With bank equity investors assuming an essential role in maintaining financial market safety and soundness, filling in this gap is critical in order to understand who holds the ultimate default risk of financial firms and how effectively they can bear this burden.

This Part has three aims. First, it describes the ownership patterns of the largest twenty-six U.S. bank holding companies,

\begin{itemize}
  \item \textsuperscript{136} \textit{Id.} The single point of entry design has faced numerous criticisms, such as whether or not it is actually workable in practice and how it might operate in the event of a subsidiary insolvency, rather than one in which the holding company can be placed in a receivership. Skeel, supra note 11, at 311–33; Derrick Cephas & Dimia Fogam, FDIC Issues ‘Single Point of Entry Resolution Strategy, WEIL GOTSHAL & MANGES: LATEST THINKING (Mar. 24, 2014), http://www.weil.com/articles/fdic-issues-single-point-of-entry-resolution-strategy.
  \item \textsuperscript{137} Admati et al., Fallacies, supra note 109, at 3.
  \item \textsuperscript{139} See AZAR, ULTIMATE OWNERSHIP, supra note 36, at 1–2 (noting high common ownership in banking from the perspective of antitrust policy); see also Elhauge, supra note 36, at 1268 (showing the prevalence of horizontal shareholding in the banking industry).
\end{itemize}
part of the thirty-four U.S. and foreign holding companies subject to the Federal Reserve’s 2017 stress tests.\textsuperscript{140} It looks at shareholders of over 5% of the common equity of these holding companies (blockholders), as listed in their proxy statements for 2011 and 2017.\textsuperscript{141}

This survey shows that the largest U.S. bank holding companies are owned to increasing degrees by blockholders from 2011 to 2017. Further, these block ownership stakes are focused in the hands of a small cohort of asset management companies: BlackRock, Fidelity, State Street, T. Rowe Price, and Vanguard.\textsuperscript{142} This Article does not advance any particular causal account to explain why some asset managers have grown their block equity stakes in the financial sector. It simply observes that a group of asset managers now features as repeat block equity owners of the largest U.S. banks, meaning that the funds they manage are now directly exposed to the risk of these big banks failing.

Second, this Part provides a descriptive outline of the asset management industry, its function and the general corporate governance practices espoused by its key members. As shown by the survey, asset managers—as block investors across a number of banks—are now critical to the health of banking. How they exercise their governance power matters for the safety and soundness of the entire financial system.

Third, this Part lays the groundwork for the argument that asset managers constitute shareholders that cannot afford to fail in their oversight role in financial regulation.\textsuperscript{143} By representing the economic interests of fund holders at multiple banking firms, the governance exercised by asset managers has enormous impact. How effectively asset managers perform this task matters for the health of financial markets as for the savers, who through

\textsuperscript{140} See Press Release, supra note 138.

\textsuperscript{141} This 2011 list does not include Citizens Financial Group, which was a wholly owned subsidiary of the United Kingdom’s Royal Bank of Scotland (RBOS) until 2015, when RBOS sold its stake in Citizens Financial Group. Dexheimer, supra note 15. The 2011 list also does not include CIT Group which reemerged from bankruptcy as an FDIC-insured bank holding company in late 2011. Touryalai, supra note 15.

\textsuperscript{142} See Elhauge, supra note 36, at 1268 (identifying four of these firms in particular).

\textsuperscript{143} This terminology references, in part, the “common ownership” literature, advanced by antitrust economics to describe the widespread ownership of U.S. companies by BlackRock, Fidelity, State Street Global, T. Rowe Price, and Vanguard. See generally Azar, Anticompetitive Effects, supra note 36, at 1514 (using “common ownership” terminology).
their fund holdings, have assumed the residual default risk of large parts of the U.S. banking system.

A. ASSET MANAGERS IN THE ECONOMY

1. What is Asset Management?

Asset managers look after and invest the wealth of savers using a variety of skills and strategies. Instead of individuals setting aside a portion of their monthly wages to invest personally, they can pay a professional asset manager a fee to do so on their behalf. By pooling the money and assets of millions of savers—both retail and corporate—asset managers cultivate expertise and market power to make investments in capital, currency, and other markets.

The kinds of products that asset managers offer their customers are varied and designed to cater to different investment objectives and risk appetites. For example, mutual funds represent the quintessential savings and money management product. Mutual funds pool savings and use this money to invest in diversified portfolios of stocks, bonds, and securities. Mutual fund clients can usually redeem the value of their investments by cashing in the shares that mutual funds issue to them, representing their particular entitlement within the fund. Depending on the fund, investors can choose between those that offer a more active trading strategy and those that are passive. In the case of active management, managers promise expertise in picking and choosing specific stocks or other securities to generate returns for the fund. For passive funds, by contrast, the value of the pool is benchmarked to the performance of a reference basket of securities (like a selected group of stocks in the S&P

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144. Professor Morley provides a more detailed description and analysis of fund organization. See Morley, supra note 19, at 1232 (noting the significance of the separation of funds and managers as the defining feature of investment pools and discussing the governance implications of this separation).


146. Morley, supra note 19, at 1234.

147. Closed-end mutual funds, in contrast to open-ended mutual funds, do not permit their customers to freely redeem their investment and cash out. Id.


149. Id.
In any event, as a product critical to the long-term economic well-being of tens of millions of mom-and-pop and corporate savers, mutual funds are subject to regulation under the Investment Company Act of 1940 (ICA) and by the Securities and Exchange Commission (SEC). Within the parameters laid out by the ICA and overseen by the SEC, asset management companies can offer customers mutual fund products, specifying strategy, likely riskiness, and redemption terms. The likes of BlackRock, Fidelity, State Street Global, and Vanguard have emerged as specialist mutual fund management companies, offering their customers a choice of funds within which to place their savings.

In addition to mutual funds, asset managers include hedge funds and private equity funds. These firms also pool assets for investment. However, by limiting themselves to a cohort of wealthy investors, hedge funds and private equity funds face a less exacting regulatory environment than mutual funds that expressly cater to a much wider swath of the public. Allowed to deploy a range of strategies, including those that may be too risky for mutual funds, hedge funds and private equity houses can provide asset management for institutions as well as wealthier investors with a higher risk tolerance.

For example, exchange-traded funds, or ETFs, usually provide passive management strategies where the value of the fund tracks an underlying index. William A. Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problems of Mutual Funds*, 33 Del. J. Corp. L. 69, 73–85 (2008) (discussing ETFs and their role in the securities market); see also Andrew Osterland, *Investors Pouring Billions into Passively Managed Funds*, CNBC (June 27, 2016), https://www.cnbc.com/2016/06/27/more-investors-are-making-the-switch-to-passively-managed-etrfs.html (noting that in 2015 and 2016, actively managed funds saw a dramatic exit of $308 billion, while passive funds like ETFs saw $375 billion in inflows).


155. See *id*.

156. See *id*.

157. This is not to suggest that hedge funds and private equity funds are not subject to securities regulation. While oversight under the ICA is lowered, owing to a smaller, wealthier clientele, hedge funds remain subject, *inter alia*, to
As of December 2014, the value of assets in U.S. investment pools came to around $25.8 trillion. This included $13.1 trillion in the U.S. mutual fund industry as well as $3.4 trillion in hedge funds. These numbers, however, tell just a part of the story.

Mutual funds, in particular, tether the wealth of Main Street homes and businesses to the fortunes of global capital markets. An extraordinary amount of U.S. household wealth is entrusted to the management of mutual funds. In all, in mid-2015, 43% of all U.S. households owned shares in mutual funds, totaling around 53.6 million householders. In the United States, 91 million individuals owned shares in mutual funds. The baby boomer generation, edging closer to retirement, constitutes the demographic with the largest share of mutual fund assets, though younger generations are investing earlier than generations past. These figures point to a dramatic deepening in the relationship between American households and asset management. For example, whereas investment companies managed just 2% of all American household financial assets in 1980, they oversaw around 22% of such assets by year-end 2015.

the usual prohibitions against fraud, insider trading, market manipulation, and disruption in their trading activities as well as other regulations with respect to how they trade, client funds, and disclosure practices. See, e.g., SEC & EXCH. COMMN., SEC PUB. NO. 139 (2/13), INVESTOR BULLETIN: HEDGE FUNDS 3–5 (2012), https://www.sec.gov/investor/alerts/ib_hedgefunds.pdf.


159. FIN. STABILITY OVERSIGHT COUNCIL, supra note 158, at 3.

160. INV. CO. INST., 2016 INVESTMENT COMPANY FACT BOOK (2016) [hereinafter INV. CO. INST., FACT BOOK].

161. Id.

162. Id. at 9–14, 112–20; see also INV. CO. INST., PROFILE OF MUTUAL FUND SHAREHOLDERS 2008 3–27 (2008) [hereinafter INV. CO. INST., PROFILE].

163. Those managing 401(k) defined benefit plans or individual retirement accounts exemplify this trend. See INV. CO. INST., PROFILE, supra note 162, at 3–27.

164. INV. CO. INST., FACT BOOK, supra note 160, at 11–13. Under the Investment Company Institute’s definition of investment companies, these holdings include assets in exchange-traded funds (ETFs), unit investment trust funds, closed-end funds, and mutual funds. Id.
Importantly, mutual fund assets managed on behalf of U.S. homes and businesses—managed on behalf of U.S. homes and businesses—are critical investors in the long-term future of corporate America. Most mutual fund assets are invested for the long-term, with 56% of assets placed in long-term equity funds. Around 41% of the 56% of assets held in long-term equity funds were invested in domestic U.S. corporations at year-end 2015. The tribulations of securities markets thus impact mutual fund performance. In 2008, following the Financial Crisis, mutual funds finished the year managing $10.3 trillion in assets, a decrease of almost $2.6 trillion from the year before, as savers pulled their investments and cashed out during the turmoil. With the near 40% decline in stock prices in 2008, U.S. equity mutual funds also found themselves suddenly poorer, leaving the households that invested in them facing deep uncertainty about the future of their 401(k)s and other savings.

2. Asset Managers in Corporate Governance

With mutual funds channeling an enormous amount of savings capital into equity and other securities, capital markets have experienced a sharp shift towards a near complete institutionalization of the investor base. As Professor Zingales notes, whereas only around 10% of all stock market investors in the 1930s were institutions, this figure has risen to over 70% in recent years. In administering large pools of household and

165. This includes assets held by mutual funds and ETFs.
166. *Id.*
167. *INV. CO. INST., FACT BOOK, supra* note 160, at 8–9. These figures include assets in ETFs, a generally more passive type of investment vehicle that tracks the performance of underlying indices. *See Morley, supra* note 19, 1235–36 (discussing ETFs); *see also Birdthistle, supra* note 150, at 71–75.
169. *Id.* at 8–9 (showing that, while equity funds suffered losses, there were inflows into fixed-income (debt) oriented funds during the Crisis).
other savings through the mutual funds they offer, asset managers make decisions about how and where to invest capital entrusted to their care. In return, they earn management and advisory fees. As Professor Morley writes, individual mutual funds are usually members of much larger networks of “fund families” organized, managed, and advised under the brand of an asset manager like BlackRock, Fidelity, or Vanguard. A public company may receive equity investments from multiple different funds from an asset manager’s fund family. For example, an S&P 500 healthcare company may see investment from a BlackRock fund that passively invests in a cross-section of S&P 500 stock. The company might also see investment from another BlackRock fund devoted to actively picking profitable healthcare stocks. In general, however, asset managers like BlackRock tend to represent all of their funds as the legal shareholder of record. This, in turn, means the asset manager holds the voting and decision-making power on behalf of all of its funds and can choose to wield this power on behalf of its funds as one joint bloc.

The significance of asset managers as shareholders in public markets inevitably draws into relief questions about how they exercise their governance power. As Professors Gilson and Gordon observe, the dominance of these institutional investors in the modern American corporation has diminished the descriptive power of the Berle–Means public company. As Berle and Means famously observed, the Anglo-American corporation is characterized by a dispersed base of shareholders and a resulting agency conflict between managers and the shareholder-owners on whose behalf they run the company.

See generally John C. Coffee, Jr., The Rise of Dispersed Ownership: The Roles of Law and the State in
fragmented group of shareholders will each be poorly motivated to exercise oversight, leaving managers to extract rents at the expense of apathetic investors.\textsuperscript{179}

Gilson and Gordon point to a new dynamic. Mutual funds and other investment funds now represent the major investors in public companies.\textsuperscript{180} As intermediaries for household and corporate savers, asset managers import a more complex interplay of conflicts in corporate governance.\textsuperscript{181} The shareholder-manager conflict is still present.\textsuperscript{182} In addition, however, Gilson and Gordon also highlight tension between mutual fund managers and their savers.\textsuperscript{183} These managers possess limited incentives to agitate on behalf of their savers to exercise active governance of the companies in which saver-wealth has been invested.\textsuperscript{184}

At first glance, this dynamic seems counter-intuitive. Asset managers—by dint of size and the capital they control—possess extraordinary power to agitate for good governance and to reduce the agency conflict between shareholders and corporate managers.\textsuperscript{185} Rather than face an uninformed group of apathetic, dispersed investors, corporate managers must now contend with expert, experienced, and well-resourced institutions that should be far less vulnerable to opportunistic rent seeking.\textsuperscript{186} Importantly, investors like BlackRock and Vanguard possess real clout. Even though individual funds within a “fund family” might each only own a small portion of the equity in a particular company, the exercise of voting rights occurs at the level of the fund family as a whole.\textsuperscript{187} Individual asset managers, like Vanguard, thus deploy the voting power of all their funds jointly as


\textsuperscript{179} BE\textsc{RLE} & ME\textsc{ANS}, \textit{supra} note 178, at 110–15.
\textsuperscript{180} Gilson & Gordon, \textit{supra} note 35, at 874.
\textsuperscript{181} \textit{See id.} at 865 (describing the conflicts arising from the unique role asset managers play).
\textsuperscript{182} \textit{Id.}
\textsuperscript{183} \textit{Id.}
\textsuperscript{184} \textit{Id.; see also} Morley, \textit{supra} note 19, at 1232 (discussing the separation between funds and managers that might give rise to conflict).
\textsuperscript{185} \textit{See Morley, \textit{supra} note 19, at 1243 (noting the power of managers and suggesting positive aspects of that power).}
\textsuperscript{186} \textit{See id.} at 1239 (noting the resources and experience management companies have).
\textsuperscript{187} Elhauge, \textit{supra} note 36, at 1268.
one entity, rather than as a collection of smaller funds, such that they all generally vote the same way on governance proposals.  

Scholars have devoted considerable study to mutual funds as investors in public companies. While this literature is too extensive to be discussed here, a few findings are worth noting. First, though the evidence should point to a motivated and effective group of investors, it is instead mixed and equivocal in its conclusions. To some degree, this makes sense. Asset managers can agitate for change. But they can also exit their investments. The option to cash out and liquidate their holdings in case of dissatisfaction offers a ready exit that acts as a brake on active engagement in governance.  

Where interventions might require effort, expense, and time, exercising the option to sell one’s shares and exit might be a more efficient use of fund resources. Agitation is expensive and legally complex. And, funds tend to diversify, limiting the gains from any single intervention.

188. Azar, Anticompetitive Effects, supra note 36, at 34–35; Elhauge, supra note 36, at 1268; see also Angela Morgan et al., Mutual Funds as Monitors: Evidence from Mutual Fund Voting, 17 J. CORP. FIN. 914, 920 (2011) (noting that, on management-sponsored proposals, individual firms are likely to vote the same way within the fund family 97.6% of the time). On shareholder-sponsored proposals, there may be greater deviation between funds within the same family. See Morgan et al., supra, at 920. The authors find a greater overall divergence in coordination between funds in the same family than other studies. Cf. Burton Rothberg & Steven Lilien, Mutual Funds and Proxy Voting: New Evidence on Corporate Governance, 1 J. BUS. & TECH. L. 157, 166 (2007) (noting an almost 98% commonality in fund votes between fund families).


191. See Stephen Choi et al., The Power of Proxy Advisors: Myth or Reality? 59 EMORY L.J. 869, 870–71 (2010). For example, some have observed a reliance on advisory firms that provide recommendations to institutional shareholders.
Importantly, the asset management industry’s compensation model further diminishes motivation on the part of fund managers for activism. Fund managers make their money by earning management and transaction fees, rather than a cut of the profits from investments. Because they are paid flatter compensation that is also heavily scrutinized and regulated by the SEC, managers may be less willing to invest in aggressive governance. Managers will be paid their regular fee and will not stand to directly earn a slice of any gain that accrues to the investment. Conversely, if investments fail to make money, a manager’s reputation might be dented, but she will continue to earn her usual fee.

Second, mutual funds often offer a low-cost, low-frills service, particularly in seeking to capture the capital of retail savers. Vanguard, for example, specifically markets itself as a manager appealing broadly to cost-conscious actors. If this effort succeeds, an asset manager increases the dollar volume of assets under its management (and the fees it earns as a result). Savers can also gain if they are able to access affordable investment vehicles. The low-fee model, however, places a constraint on about how to vote. Id. at 870. Proxy firms like Institutional Shareholder Services (ISS) advise shareholders on how best to vote on proposals. Id. at 871; James Cotter et al., *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 55 VILL. L. REV. 1, 2 (2010) (“We find that mutual funds tend to vote in line with ISS recommendations across the board. . . . [M]utual funds vote consistently with ISS recommendations more often than do all shareholders.”).


194. See Bhide, *supra* note 189, at 43 (noting that “[l]osses do not necessarily establish managerial incompetence since the alternatives might have been worse”).


the scope and intensity of the corporate governance efforts that managers may be willing to perform. Lengthy activist campaigns may be economically unattractive where managers cannot recoup the costs of mounting them from their clients.\textsuperscript{198} For fund managers expressly offering a cheap investment product, what managers can charge from their fund holders is likely to be tightly circumscribed. The appeal of mass-market investment products has contributed to the growth of passively managed funds, where returns are benchmarked to a particular index (like the S&P 500).\textsuperscript{199} In overseeing passive funds, managers do not routinely buy and sell securities to influence the public companies where they are invested; they only adjust their portfolios at regular intervals to reflect the risk and diversity of their chosen benchmark.\textsuperscript{200} Passive funds have proven enormously popular in recent years. Between 1998 and 2014, the share of equity mutual fund assets held under passive management grew to 33.5%, tripling in the course of less than two decades.\textsuperscript{201}

As Professors Gilson and Gordon argue, these industry dynamics push against mutual fund asset managers adopting an active approach to corporate governance.\textsuperscript{202} Importantly, competition between top asset managers is unlikely to bridge this motivation gap. If multiple asset managers—like BlackRock, Fidelity, and Vanguard—control funds invested in the same company, then activism by one manager will lead to gains for the other managers too.\textsuperscript{203} Also, the activist manager will have to charge its own savers higher fees to reflect the transaction costs of agitation.\textsuperscript{204} This means that the active manager loses against its competitors on two fronts: (1) its efforts create returns for its competition as well as for itself; and (2) its returns to savers are lower because it must charge them higher fees for action.\textsuperscript{205} Un-

\textsuperscript{198} See Gilson & Gordon, supra note 35, at 902–03 (noting that activists incur costs and that gains have to be shared with other shareholders).
\textsuperscript{199} Id. at 885–86 (describing low-cost index investing).
\textsuperscript{200} Id.
\textsuperscript{201} Appel et al., supra note 193, at 112.
\textsuperscript{202} See Gilson & Gordon, supra note 35, 889–95 (discussing various dynamics that influence mutual fund managers to adopt passive approaches).
\textsuperscript{203} See id. at 902–03 (noting that there are costs associated with activism and that gains have to be shared with other shareholders).
\textsuperscript{204} See id. at 892 (observing that the costs incurred by taking on an activist role will “reduce the fund’s returns”).
\textsuperscript{205} Id.
surprisingly, then, studies suggest that mutual funds have generally played a backseat role in governance, reflecting a kind of strategic, rational passivity. For example, according to one 2016 industry study on executive compensation, BlackRock supported pay practices 96.3% of the time at its S&P 500 firms.

This picture, however, may be more nuanced. One study pointed to the important role of “voice” in corporate governance. Rather than perform public acts of activism—such as voting and visible agitation—asset managers may instead engage in backstage interventions. Rather than make displays of their activity, funds may use their power and knowledge to make changes through private engagement with management. In his 2017 annual letter to corporate CEOs, BlackRock’s Larry Fink outlined his aim to use the firm’s influence to promote better governance and long-term value creation. And scholars have also argued that passive managers may still influence corporate management despite their low-cost, passive approach. For example, because they invest for the long term and do not exercise the option to exit (by selling), managers at passive funds actually have a strong incentive to push for good corporate governance outcomes.

One study further observes that passively managed funds can, in fact, produce results for

206. Cotter et al., supra note 191, 8–12 (noting that higher legal compliance costs as well as more cynical incentives to curry favor with employer-based thrift plans may have motivated the historically passive governance role played by mutual funds).

207. Alexandra Stevenson & Leslie Picker, A Rare Corner of Finance Where Women Dominate, N.Y. TIMES (Jan. 16, 2017), https://www.nytimes.com/2017/01/16/business/dealbook/women-corporate-governance-shareholders.html. However, BlackRock also reported that it had voted against pay packages at ten out of fifty companies where companies reported the highest pay. Id.

208. Morgan et al., supra note 188, at 927 (noting a significant divergence across funds “with respect to voting on shareholder proposals”).


210. Id. at 2907.

211. Id. at 2911.

212. Fink, supra note 37.

213. See, e.g., Roberta Romano, Public Pension Fund Activism in Corporate Governance Reconsidered, 93 COLUM. L. REV. 795, 833 (1993) (noting that being locked into an index may lead passive managers to place a greater emphasis on activism). But see Jill E. Fisch et al., Passive Investors, (June 29, 2018) (unpublished manuscript) (on file with Minnesota Law Review) (analyzing the incentives of passive index funds to exercise good governance, and noting, for example, the ability of fund holders to sell and exit as a factor motivating managers to diligently oversee investments).
corporate governance, with their interventions influencing benefits like increased board independence. Nevertheless, historical practices have largely pointed to fund managers being more passive in their corporate governance than their size and clout would suggest. Gilson and Gordon’s argument provides a compelling explanation as to why this might be the case. Fund managers lack sufficient skin in the game to behave in the manner of engaged, activist investors. They thus benefit when more aggressive investors like hedge funds take a lead in surveillance and agitation.

3. Asset Managers in the Banking Industry

BlackRock, Fidelity, State Street, T. Rowe Price, and Vanguard have emerged as important equity investors in banking. These asset managers have utilized the fund capital under their charge to deeply invest in the equity of large U.S. bank holding companies.

It makes sense that asset managers should flex their economic power in the banking industry. Controlling trillions of dollars’ worth of assets, asset managers invest widely across the spectrum of American public companies. This is evident in the case of BlackRock—the largest asset manager in the world. Founded in 1988, the firm has expanded rapidly to hold a significant place in everyday economic life. In 2015, BlackRock reported managing assets worth over $4.6 trillion, up from $3.5 trillion in 2011. BlackRock invests in equity-based investments around the world as well as in fixed-income (debt) securities, like bonds, as well as commodities, real property, and investment funds.

214. Appel et al., supra note 193.
216. Id. at 866–67.
217. See Elhauge, supra note 36, at 1268 (noting that, in 2013–14, JPMorgan Chase, Bank of America, and Citigroup were all heavily invested in by major mutual funds).
218. Id.
220. BLACKROCK, BUILT FOR CHANGE: 2015 ANNUAL REPORT 1, 3 (2016) [hereinafter BLACKROCK, 2015 REPORT] (showing that the growth in the value of assets under management can be ascribed to inflows of new assets, growth in the value of securities already held, as well as, inter alia, acquisitions).
222. BLACKROCK, 2015 REPORT, supra note 220, at 2–3; see also The Mono-
While smaller than BlackRock, asset managers like Fidelity, Vanguard, State Street Global, and T. Rowe Price also control trillions of dollars’ worth of capital. Vanguard, the second-largest U.S. asset manager after BlackRock, administered just over $5.1 trillion in assets under management (AUM) as of January 31, 2018. State Street Global Advisors oversaw around $2.8 trillion in AUM at the year-end of 2017; Fidelity held $2.5 trillion in AUM as of March 31, 2018; and T. Rowe Price held $1.07 trillion in AUM as of July 31, 2018.

This cohort of asset managers provides capital to public companies on behalf of household and corporate savers. BlackRock, in particular, appears to be a ubiquitous investor, reportedly holding a stake in almost every single U.S. publicly-traded company. As Professor Einer Elhauge notes, BlackRock, Fidelity, State Street, and Vanguard together hold 80% of all stock in S&P 500 corporations.

It is unsurprising that the largest asset managers—custodians of the deepest pools of capital anywhere—should also invest heavily in banking. For one, they invest across industries, creating a diverse portfolio of securities in their fund families. Indeed, if asset managers offer funds that simply track an index, like the S&P 500, then large, publicly traded banking firms cannot easily be left out of the portfolio. And if finance is profit-generating, a failing by fund managers to take advantage might be seen as breaking a promise to clients to choose lucrative stocks.

The results of U.S. bank holding ownership data from proxy statements for the years 2011 and 2017 point to an increasing

_The Rise of BlackRock, supra_ note 18, at 13 (discussing the wide variety of industries major mutual funds are invested in).

_See_ Elhauge, _supra_ note 36, at 1268 (discussing the ways in which managers attempt to appeal to their shareholders’ interests).
number of blockholders in bank capital structures. Further, it shows that these block stakes are concentrated in the hands of a few major asset managers: BlackRock, Vanguard, State Street Global Advisors, Fidelity, and T. Rowe Price. In 2017, for the twenty-six publicly traded U.S. bank holding companies subject to the Federal Reserve’s 2017 stress-test, twenty-five out of the twenty-six firms included both BlackRock and Vanguard as owners of more than 5% of common stock. State Street Global featured as a blockholder in twelve firms, Fidelity in six firms, and T. Rowe Price in five holding companies. In all, BlackRock and Vanguard constituted the most prolific large shareholders, featuring in twenty-five of the twenty-six banks studied (though not always in the same banks).

Contrast these ownership patterns with those seen in the 2011 proxy statements. Surveying twenty-four firms in the proxy statements of 2011, only ten bank holding companies listed BlackRock as a blockholder, seven included Fidelity, and State Street and Vanguard each appeared as blockholders in only one bank. In 2011, several leading bank holding companies, such as Bank of America or PNC Financial, reported having no large blockholders at all.

The reasons driving this increase in the higher equity holdings of asset management firms in bank holding companies in 2017 are complex and merit separate empirical study. I do not make any claim here as to a particular explanatory or causal account regarding this trend.

Still, these five big asset managers—and the funds they represent—now clearly constitute critical providers of equity capital to the largest, most complex U.S. banks. More importantly, as blockholders at multiple bank holding companies, they each also possess voting and governance power to exercise control of these critically important financial firms.

231. See infra Charts A, B, and C.
232. See infra Charts A, B, and C.
233. Neither Citizens Financial Group nor CIT Group were included in the 2011 stress-test, while both were included in the 2017 stress-test. Citizens Financial was a wholly-owned subsidiary of the Royal Bank of Scotland (UK) until 2015. Daxheimer, supra note 15. CIT Group was undergoing bankruptcy in 2009. Touryalai, supra note 15. CIT Group reemerged as an FDIC-insured bank holding company in late 2011. Id.
234. See infra Chart B.
B. BANK EQUITY SUPPLIERS: SURVEY RESULTS

These charts set out the percentage ownership interests of shareholders with over 5% of equity in publicly traded U.S. bank holding companies subject to the Federal Reserve’s mandatory stress tests for large and complex banks. The information here is taken from the banks’ proxy statements for years 2017 and 2011. For simplicity, I include information on the five asset managers that appear as blockholders for five or more bank holding companies. Numerous asset managers also hold block stakes in U.S. banks but at fewer than five holding companies. Their ownership details are not included here.

Chart A - Ownership Chart 2017 Proxy Statements

235. This Chart shows the results of my analysis of U.S. bank holding ownership data taken from each bank’s 2017 proxy statement. The background data is on file with the author.
Chart B - Ownership Chart 2011 Proxy Statements

Block Ownership of Banks: Proxy Statements 2011

Chart C – Approx. Average % Ownership 2017 Proxy Statements

Average % Block Ownership Stake 2017

236. This Chart shows the results of my analysis of U.S. bank holding ownership data taken from each bank’s 2011 proxy statement. The background data is on file with the author.

237. This Chart shows the results of my analysis of U.S. bank holding ownership data taken from each bank’s 2017 proxy statement. The background data is on file with the author.
III. TOO BIG TO FAIL SHAREHOLDERS

As shown in Parts I and II, post-Crisis capital regulation places special emphasis on ensuring that bank holding companies fund themselves more fully through equity. In the years since the passage of the Dodd-Frank Act, the real-world composition of these capital buffers shows two major trends: (1) an increasing number of blockholders at the largest U.S. banks; and (2) the preeminence of a small group of shareholders as blockholders across multiple major firms in the banking system. With equity key to shoring up the safety and soundness of large banks post-Crisis, these asset managers have come to occupy a particularly important place on the front lines of financial risk management.

In turn, public policy also depends on the ability of fund managers to protect their savers from the consequences of risk-taking at the banks where their funds invest. If a bank fails, its shareholders will shoulder the cost.238 And because banks can often collapse contagiously, potentially afflicting multiple firms, these losses, too, can multiply.239 Unlike other types of companies, where the fall of a big name spells good news for its competitors, the collapse of a large bank is likely to trigger fears of a much greater, system-wide failure.240 For asset managers invested across multiple competing banking firms, then, the demise of one may well portend trouble at others. Even if authorities do not formally trigger wind down processes by mandating that the value of equity be wiped out to pay off creditors, just the prospect of such an event is likely to depress bank share prices and, as a result, the value of asset managers’ fund portfolios.241

This Part examines how effectively asset managers might perform their role as overseers of risk at the banks where their funds are invested. Because they legally represent their funds at numerous large banks at once, the financial system is systemically impacted by the incentives, skills, and shortcomings of as-

238. See Diamond & Dybvig, supra note 71, at 403 (noting that during bank runs, banks are forced to liquidate all of their assets, often at a loss).
239. RICKS, supra note 4, at 5; Diamond & Dybvig, supra note 71, at 401.
240. See RICKS, supra note 4, at 110–11 (arguing that an initial shock to the banking system can trigger a larger panic).
set managers in exercising this governance power. This Part argues that asset managers possess unique advantages, bringing a less risk-seeking model of equity investment to bank governance.

A. THE CHALLENGE OF SHAREHOLDER GOVERNANCE IN BANKING

Corporate governance matters in financial regulation. But, exercising this governance faces unique and costly challenges. As Professors Armour and Gordon observe, banks present a more unique governance proposition than other types of companies. For a start, giving shareholder interests overall primacy, as is conventional in corporate law, sits uneasily with public policy. With banks supported by an explicit public safety net, pursuing shareholder interests at the expense of all else can result in costly consequences for the public purse. Beyond just creating a different set of trade-offs for shareholders, banks are also notoriously tricky to understand from the standpoint of how they are run, the risks they assume, and how these

242. See Steven L. Schwarcz, Rethinking Corporate Governance for a Bondholder Financed, Systematically Risky World, 58 WM. & MARY L. REV. 1335, 1356–63 (2017) [hereinafter Schwarcz, Rethinking Corporate Governance] (arguing for a greater duty to bondholders in financial institutions); Steven L. Schwarcz, Too Big to Fool: Moral Hazard, Bailouts, and Corporate Responsibility, 102 MINN. L. REV. 761, 787–96 (2017) (advocating for more internal regulation of risk-taking); Steven L. Schwarcz, Regulating Corporate Governance in the Public Interest: The Case of Systemic Risk, Keynote Address at the National Business Law Scholars Conference (June 23, 2016) [hereinafter Schwarcz, Public Interest] (arguing that corporate governance laws should require some duty to the public); see also David Min, Realigning Bank Governance 27–29 (unpublished manuscript) (on file with author) (discussing literature investigating the importance of corporate governance).


244. Omarova, supra note 243, at 1031–32.

245. See id. (noting that the Crisis was an example of how "socially destructive" it can be when bank managers only pursue "short-term private gains").
risks should be priced. To appreciate the default risks faced by shareholders, banks represent a daunting informational challenge, necessitating deep pockets and expertise to overcome, if it can, in fact, be fully overcome at all.

1. The High Costs of Bank Corporate Governance

   The costs of corporate governance tend to be especially high for financial institutions. With asset managers charged with corporate governance at multiple large banks, these costs grow in lockstep. As Professors Mehran and Mollineaux observe, understanding the measure of these costs must begin with a more fundamental inquiry about what it means to govern a large and complex financial institution: namely, what does a well-governed financial firm look like? As Armour et al. note, banks cannot simply prioritize shareholder profits. To do so would cause bank managers to place an unduly high premium on risk-taking and on maximizing returns for shareholders at the expense of market stability. As made clear by the 2008 Financial Crisis, the price tag for such risk-taking can run into the trillions of dollars, not to mention cause long-term economic damage.

   At the same time, financial conglomerates like JPMorgan Chase or Citigroup now perform a multiplicity of functions beyond just taking deposits and lending. These all require the bank to take risks, to varying degrees. Large banks extend credit, underwrite securities offerings, facilitate trading in these securities as well provide critical financial infrastructure (e.g., for making payments). In seeking to formulate their approaches

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246. Choi et al., supra note 191, at 870–79 (discussing risk metrics, investor influence, and shareholder activism); Cotter et al., supra note 191, at 6–12 (discussing risk metrics).

247. See discussion infra Part III.A.1.


250. See id. at 374 (noting that increased risk may result in more gains for shareholders, but also cautioning that a “bank failure can trigger contagion in other parts of the financial system”).


252. See Armour et al., supra note 249, at 433–34 (discussing the ways in which banks have changed and the ways in which new risks have arisen).

253. See Levitin, supra note 61, at 411–13, for an explanation of “narrow banking.” See also Morgan P. Ricks, Safety First? The Deceptive Allure of Full
towards corporate governance, asset managers must first decide how much risk a bank should take.\textsuperscript{254} While lawmakers have called for an end to “too big to fail” banks and taxpayer funded bailouts, these fuzzily-formulated bounds leave plenty of room for debate and disagreement about what a good bank should look like.\textsuperscript{255}

With these uncertainties about outcomes in bank governance, shareholders will likely have competing views about how to resolve the tension between a bank’s profit-seeking role and its public function. Divergences in perspective between institutional shareholders can contribute to higher decision costs, reflecting the challenges of shareholders coordinating with each other and in deciding on and taking action.\textsuperscript{256} In turn, these high decision costs can reduce the motivation of even interested investors to engage in governance.\textsuperscript{257} At the very least, they set a threshold at which shareholders will be willing to intervene: shareholders move only when the gains offset the transaction costs involved in any action.\textsuperscript{258} Where these costs are high to


\textsuperscript{254} See \textsc{Mehran & Mollineaux}, supra note 248, at 11 (discussing the many executives that influence major decisions, including determining risk profiles).

\textsuperscript{255} See, e.g., \textsc{Wall Street Reform: The Dodd-Frank Act}, WHITE HOUSE, https://obamawhitehouse.archives.gov/economy/middle-class/dodd-frank-wall-street-reform (last visited Oct. 22, 2018) (discussing Wall Street Reform, steps taken to hold banks accountable, and the policy aversion to future bailouts). On the controversies surrounding optimal riskiness at banks, to cite just one example, there remains considerable debate about whether and to what extent banks ought to invest in the commodity markets, to buy and sell oil or metals. While lucrative, it may result in banks facing large liabilities in case of a natural disaster, or a crash in the price of a commodity. See Donna Borak & Liz Hoffman, \textsc{Fed Targets Big Bank Commodity Lines}, WALL ST. J. (Sept. 23, 2016), https://www.wsj.com/articles/fed-proposes-limits-on-bank-commodity-trading-1474646400 (discussing policy proposals to reduce bank involvement in commodity markets); see also Neel Kashkari, President & CEO, Fed. Reserve Bank of Minneapolis, Lessons from the Crisis: Ending Too Big to Fail, Remarks at the Brookings Institution (Feb. 16, 2016) (advocating for a greater focus on breaking up large banks); Ben S. Bernanke, Ending “Too Big to Fail”: What’s the Right Approach?, BROOKINGS (May 13, 2016), https://www.brookings.edu/blog/ben-bernanke/2016/05/13/ending-too-big-to-fail-whats-the-right-approach (discussing policy proposals for ending “too big to fail” financial institutions).

\textsuperscript{256} See McGahery, supra note 209, at 2921 (noting that investors may have conflicts of interest and may be wary of potential legal risks that could result from coordinating with each other).

\textsuperscript{257} See id. at 2922 (noting that there are many potential impediments to investors engaging in governance).

\textsuperscript{258} See id. at 2921 (observing that investors want to avoid free riders and
start with—as in bank regulation—shareholders may be more likely to be rationally apathetic.\textsuperscript{259}

Indeed, institutional shareholders—like mutual funds—routinely disagree with one another (and, occasionally, within the fund families themselves) in everyday, nonbanking contexts.\textsuperscript{260} In one study of twenty-four of the largest mutual funds, the authors found agreement among them on certain issues, but divergence on others. While large funds agreed on themes like opposition to antitakeover strategies, variation existed on other topics such as compensation and the degree of deference to be accorded to management.\textsuperscript{261} These usual corporate law problems inevitably affect how banks operate as they do other types of companies.

However, overlaid on these general disagreements are considerations about how bank operations impact the riskiness of the firm, its likelihood of needing to access the public safety net, and its threat to financial stability.\textsuperscript{262} The issue of executive compensation for bankers, for instance, exemplifies an area where corporate governance and financial riskiness intersect. Following the Crisis, policymakers blamed lucrative pay packets and generous performance bonuses as a contributing cause of the collapse.\textsuperscript{263} Pursuant to the Dodd-Frank Act, shareholders must now examine the merits of compensation packages from the usual corporate law lens as to whether or not such pay reflects that activism only makes sense when the activist receives benefits much larger than their costs).

259. See id. at 2922 (noting that shareholders require incentives in order to be active and that, when the incentives aren’t there, shareholders are not motivated to engage).

260. See Morgan et al., supra note 188, for an explanation of disagreements between fund families.

261. Burton Rothberg & Steven Lilien, Mutual Funds and Proxy Voting: New Evidence on Corporate Governance, 1 J. BUS. & TECH. L. 157, 176–78 (2006). This paper also noted a large amount of consensus within fund families that tended to vote their proxies as a block. Id. at 167. However, it also noted variations between funds with regards to deference to management. Id. at 178–79. In this study, for example, the authors noted that the five largest funds tended to vote against management 17% of the time on average—the highest being Vanguard (29%) and the lowest being T. Rowe Price (8%). Id. at 167. See Morgan et al., supra note 188, for a literature review discussing the practices of mutual fund voting patterns.

262. See MEHRAN & MOLLINIAUX, supra note 248, at 3 (“As market monitoring decreases, it becomes more likely that banks can increase their systemic risk unnoticed, which can lead to greater instability of the financial system.”).

an executive’s contribution to corporate growth. But, for banks, this scrutiny also includes deliberation about how any pay packet affects the bank’s behavior as a risk-agent in the market. Ultimately, this kind of inquiry distills down to complex and contentious questions about what banks can and should do and how much risk they can safely take. Given that these fundamental inquiries remain unanswered and subject to different views between investors, decision costs for bank corporate governance set a high threshold for action.

Indeed, the costs’ impact may be especially heavily felt by asset managers. As holders of block stakes across numerous financial firms, asset managers have to reconcile conflicts along two axes: (1) as blockholders, an asset manager might have several funds within its fund family invested at a large bank. These individual funds might have varying investment objectives (e.g., one may be passively indexed while another is actively managed) and disagreements about bank function may arise out of these divergences; and (2) blockholders may reasonably disagree with one another. Holding large economic stakes at large banks, a difference of views among expert investors is likely, if not to be expected.

**Information Costs:** Information costs also heavily impact bank corporate governance. Large financial institutions present especially steep knowledge gaps for shareholders. First, shareholders must wrestle with informational complexity embedded

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264. See, e.g., Bebchuk & Spamann, supra note 243, at 271–72 (noting the link between high pay at banks and risk-taking in the 2008 financial crisis); Randall S. Thomas et al., *Dodd-Frank’s Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?* 97 CORNELL L. REV. 1213, 1218–22 (2012) (discussing the implications of the Dodd-Frank Act’s “say-on-pay” proposals for shareholder’s input into executive compensation packages at banking institutions).

265. See, for example, Hockett, supra note 243, at 1085–86, and Omarova, supra note 243, at 1031, for a discussion by both authors of the difficulties interpreting the term “systemic risk” for the purposes of bank regulation.

266. See Elhauge, supra note 36, at 1268. Many of the top mutual funds own significant percentages of major banks. *Id.* As such, it is extremely likely that they would have multiple funds within their fund families invested at the same bank.

267. See Modigliani & Miller, supra note 84, at 292–93 (explaining that managers have to balance other objectives outside of simply “furthering the interests of the owners”); Morgan et al., supra note 188, at 915 (noting that “funds do not always vote consistently within fund families”).

268. See Morgan et al., supra note 188, at 927 (noting that some divergence arises from the type of fund and from the subadvisor).
within the organizational structure of financial institutions.\textsuperscript{269} That large and complex firms defy a clear understanding of their activities and firm structure has become something of a truism after the Crisis.\textsuperscript{270} Organizationally, major financial holding companies comprise sprawling networks of domestic and international subsidiaries, affiliates, and branches.\textsuperscript{271} When Lehman failed in 2008, its collapse implicated 209 subsidiaries in twenty-one countries that were party to 900,000 derivatives contracts and subject to $1.2 trillion in creditor claims.\textsuperscript{272} Regulatory efforts post-2008 have sought to simplify organizational structures. For example, large banks must now provide regulators with a self-styled living will, designed to provide a roadmap through a simulated bankruptcy.\textsuperscript{273} Such measures appear to have had some effect in reducing the tangle of entities and economic relationships characteristic of large banks before the Crisis.\textsuperscript{274} For example, Bank of America—the third largest U.S. bank, as measured by asset size—notes seventeen material entities in its will.\textsuperscript{275}

\textsuperscript{269} See Mehran & Mollineaux, supra note 248, at 1–3 (noting that many organizational and fundamental aspects of the governance of financial institutions are not easily understood).

\textsuperscript{270} Id. at 3–5.


\textsuperscript{272} Id. at 175–76.


\textsuperscript{275} Bank of Am., Bank of America Corporation 2017 Resolution Plan Submission: Public Executive Summary 5 (2017); see also 12 C.F.R. § 381.2(c) (2011) (“Material entity means a subsidiary or foreign office of the covered company that is significant to the activities of a critical operation or core business . . . .”). The definition of material entities for the living wills resolution provision is narrower and may not have applied to the 209 subsidiaries that were subject to the Lehman Brothers bankruptcy in 2008. In other words, today’s banks may have a greater number of subsidiaries whose operations are not considered sufficiently material to be included within the resolution plan. But the problem is far from fixed. For example, regulators identified deficiencies in the living wills of five leading banks in April 2016, suggesting that concerns about complexity remained live. Ryan Tracy, Regulators Reject “Living Wills” of Five Big U.S. Banks, Wall St. J. (Apr. 13, 2016), https://www.wsj.com/articles/regulators-reject-living-wills-of-five-big-u-s-banks-1460548801.
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But organizational complexity is just one source of the informational deficits faced by asset managers as bank shareholders.276 Gaining insight into bank activities, business lines, and assets still represents a challenge despite efforts to simplify corporate structures.277 Importantly, even with a more intensive regulatory regime following the Dodd-Frank Act, the largest banks in the United States have grown steadily in size, as measured by the value of their assets. Together, Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, and Wells Fargo held around $8.6 trillion in assets in 2011, equivalent then to 56% of the U.S. economy and up by 43% from 2008.278 In 2016, this figure had risen to approximately $9 trillion, slowing since 2011, but nevertheless pointing to bank balance sheets of enormous economic heft and complexity.279


279. The figures for 2016 were taken from the living wills submitted by these five biggest banks to regulators as part of their compliance obligations under the Dodd-Frank Act.
The activity and asset compositions of the largest U.S. banks pose serious hurdles for shareholders seeking to understand how much risk financial firms are assuming as a precursor to governance. To understand a bank’s default risk, the composition of its assets and liabilities, as well the overall viability of its business, shareholders must invariably invest considerable time, research, and expertise. Such a task entails examining a bank’s opaque, generally illiquid bank loans, its underwriting and trading activities, as well as its international operations.

Large bank oversight thus requires monitors to access detailed information about the bank’s activities and worldwide operations.

This is not to suggest that institutional investors are bound to fail at this task. In one early study, for example, Professors


281. See MEHRAN & MOLLINEAUX, supra note 248, at 21 (discussing the variety of ways in which information about banks can be interpreted and distorted, and noting that, even with copious amounts of information, financial institutions can still remain “opaque”).

282. See id.

Flannery and Houston noted that investors were able to price equity securities of a banking firm about as well as they did for a nonbanking one. 284 But the difficulties of valuing opaque and often illiquid assets like loans make studying banks and their riskiness difficult and costly. 285 In another pre-Crisis study on the ease of measuring default risk, the author noted that ratings by Moody’s and Standard and Poor’s differed most from each other when examining banks and insurers. 286 The higher the proportion of a bank’s assets that were focused on loans, the more these ratings diverged. 287 In other words, ratings agencies struggled to arrive at a consistent interpretation of bank riskiness, particularly for larger banks holding more loans on their balance sheets. 288 These differences of opinion suggest that understanding complex bank balance sheets is far from easy. And as made clear during the Crisis, valuing credit risk can be tricky to get right when financial engineering enables such risk to be sliced, diced, and traded between financial firms. 289

Second, acquiring information is a challenge in matters concerning bank safety and soundness. 290 In contrast to securities regulation, where disclosure and transparency are emphasized, banking has traditionally—and for good reason— favored a more discrete approach. 291 To help investors seeking out information on public companies, securities rules establish a detailed regime for ensuring that markets receive a regular flow of materially important information. 292 With companies required to reveal

286. Id. at 10.
287. Id. at 3.
288. Id. at 13–14.
289. See, e.g., ADAM B. ASHCRAFT & TIL SCHUERMANN, FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 318, UNDERSTANDING THE SECURITIZATION OF SUBPRIME MORTGAGE CREDIT 9 (2008) (noting that asset managers and investors are able to trade).
290. MEHRAN & MOLLINEAUX, supra note 248, at 5.
291. See id. at 28 (noting that voluntary disclosures could harm banks by prompting greater scrutiny).
deep troves of detailed, internal information, investors do not have to pay the costs of research or of negotiating access to corporate data.\textsuperscript{293} Because of this mechanism, investors freely receive a regular flow of financial statements, audited accounts, a narrative on management, corporate structure, risk factors, and prospective plans.\textsuperscript{294}

Banks are different. If holding companies are publicly traded, they must supply corporate data to the market in accordance with securities rules and be subject to the market discipline that this disclosure implies.\textsuperscript{295} However, banks also face the perennial risk that any sort of bad news might push depositors and short-term creditors to withdraw their funds, triggering bank runs, panic, and contagion.\textsuperscript{296} This danger means that regulators often hold back key bank data from the public domain.\textsuperscript{297} Particularly when information develops out of bank supervisory assessments like stress tests, its dissemination can trigger the very crisis that regulators are working to avert.\textsuperscript{298} While this approach is gradually changing—with more information being made available by regulators (e.g., some stress test results)—public policy has traditionally dictated that fuller data about the inner health of banks be kept deliberately veiled.\textsuperscript{299}

This secrecy heightens information costs and dampens the incentives of institutions to exercise active governance.\textsuperscript{300} Where acquiring knowledge on the workings of banks is expensive, investors will wish to assure that their payoff is greater than what

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\textit{Capital Markets: A Review of Theory and Empirical Work, 25 J. FIN. 383 (1970) (arguing, in what has become the seminal article on the topic, that information available to the market is captured in market prices as part of an efficient market).}
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\textsuperscript{293}. See Coffee, supra note 292, at 724 (noting that there is improved efficiency when investors do not have to gather information on their own).


\textsuperscript{295}. Id.

\textsuperscript{296}. MEHRAN & MOLLINEAUX, supra note 248, at 9.

\textsuperscript{297}. See id. at 21 (noting that there have been concerns that the disclosure of data regarding the health of the banking industry could trigger bank runs).

\textsuperscript{298}. See id. (noting that stress-tests and other measures of bank health can have implications for the entire sector and that disclosure of results could increase worries).

\textsuperscript{299}. See id. (discussing “the importance of information in addressing the public’s desire for banks to be safe yet innovative”).

\textsuperscript{300}. See McCahery, supra note 209, at 2922 (noting that shareholders require incentives in order to be active and that, when the incentives are not there, shareholders are not motivated to engage).
they invest.\footnote{See id. at 2921 (observing that investors want to avoid free riders and that activism only makes sense when the activist receives benefits much larger than their costs).} Investors will also need to spend money on executing intervention strategies, further raising the threshold at which they take action.\footnote{See Gilson & Gordon, supra note 35, at 902–03 (noting that activists incur costs).} Arguably, asset managers will have limited appetite to deal with such costs. Where fund managers wish to keep overall transactions costs down, investing in resource intensive research and analysis is likely to appear undesirable.

Particularly for larger, more complex banks that are presenting a mix of decision, implementation, and information costs, rational apathy presents an efficient course of action even for well-resourced investors.

2. Regulatory Costs and Rational Passivity

In addition to costs, the design of bank regulation creates incentives for shareholders to refrain from performing governance. This regulatory framework hardens the rational apathy of asset managers towards corporate governance.\footnote{See id. at 864 (arguing “against recent proposed regulatory changes that would undercut shareholder activists’ economic incentives by making it harder to assemble a meaningful toehold position in a potential target”).}

To stave off the threat of a bank run and to prevent contagion from spreading into the economy, banks benefit from a number of support mechanisms: (1) deposit insurance, (2) emergency credit from the Federal Reserve and potential implicit guarantees of assistance, and (3) extensive oversight at the state and federal level. While such assistance can come at high taxpayer expense, its gains are evidenced by the assurance of a safer financial system.\footnote{See supra note 11 and accompanying text.}

Guarantees of state support, however, can distort the incentives of shareholders to be diligent in how they oversee a complex bank.\footnote{MICHAEL BARR ET AL., FINANCIAL REGULATION: LAW AND POLICY 239–50 (2016); Diamond & Dybvig, supra note 71.} For a start, banks are overseen by a multiplicity of public regulators, tasked with ensuring their safety and soundness. Additionally, banks are supported by deposit insurance, access to the Federal Reserve discount window, and possible bailout assistance in the event that a bank is too big to fail. With the taxpayer investing heavily in bank surveillance, it makes little
sense for shareholders to invest in further monitoring and intervention. With shareholders holding only incomplete reserves of information on these opaque and complex institutions, with decision-costs attached to action, it makes sense for shareholders to just rely on public oversight as a cheaper and possibly more effective approach to bank supervision.

In other words, express and implicit state support through deposit insurance, emergency credit, as well as an extensive supervisory apparatus can further limit the interest of investors to govern diligently. With corporate governance decisions also subject to health-checks by regulators, the scope of investor action is further curtailed by the need to secure regulatory sign-off. Ideas about mergers, remaking corporate structure (e.g., through sell-offs of bank units), or suggestions for future business (e.g., engaging in commodities trading) will be subject to scrutiny and approval by bank regulators seeking to maintain safety and soundness.

Rational shareholder apathy is likely to be particularly pronounced at the largest banks given their high information costs, coordination problems, and decision uncertainties. Accounts of shareholder activism in banking remain limited. Emerging evidence appears to support the observation that shareholders are likely to remain disengaged from governance. A study examining all documented instances of shareholder action at banks between 1994 and 2010 found that bank holding companies do experience activism and intervention by shareholders—337 banks experienced actions during the sample period. However, not all banks were targeted equally. Rather, activists focused their attention on smaller banks characterized by high agency costs, low firm value, a smaller geographical footprint, and growth potential. Activists generally sought to engage management and to suggest strategic changes (altering business lines, improvements in operational efficiency, etc.) as well as to encourage banks to declare dividends.

306. Concentration Limits (Regulation XX), 12 C.F.R. pt. 251 (2014) (limiting the merging of banks that might create a single bank whose liabilities would be 10% or more of all U.S. liabilities). On activity restrictions, see, Omarova, Unfulfilled Promise, supra note 53, at 1692–95. On living wills requiring sharper focus and on simplifying corporate structures, see discussion supra Part III.A.


308. Id. The research on shareholder activism is extensive. See, e.g., Alon
Anecdotally, instances of shareholder activism at the largest banks have tended to be much less frequent. A cohort of specialist activist hedge funds, such as Trian Fund Management (that targeted State Street and Bank of New York Mellon) or Greenlight (that targeted Citizens Financial Group and CIT Group), has taken the initiative. This paucity of action should not be surprising, given the costs and complexities of staging interventions at the largest, most complex, and tightly regulated banks.

B. WHY SHAREHOLDERS FAIL IN BANK GOVERNANCE

Scholars have pointed to bad corporate governance as a key cause driving the 2008 Financial Crisis. Theory explains why shareholders and managers at banks possess incentives to push for short-term, risky profits. Because a small group of asset managers now hold equity across major U.S. banks, theory would suggest that they will be especially vulnerable to the pull of these problem motivations.

Theory also suggests that bank shareholders seek out risk. As residual claimholders and the bearers of default risk, shareholders gain by encouraging a bank to take on risk. They win when it performs profitably. If risks materialize, shareholders are wiped out. Particularly as a firm edges toward a collapse, these distortions become sharper as shareholders and managers go for broke to seek out a big win. Incentives to push for risk


In the case of State Street, for example, Trian tried to effect a change in management as well as to advocate for lower executive compensation and cost savings. For further discussion, see infra Part III.B.


312. *Id.*

become more powerful where shareholder winnings can be maximized through leverage. Because banks can borrow more cheaply relative to other firms, shareholders are well placed to push for greater risk-taking at the expense of a bank’s creditors.\footnote{314}{Squire, supra note 313.}

For shareholders at the largest banks, these motivations will be even more compelling. The chance that shareholders are wiped out will be reduced by the promise of expansive public support: (1) the Federal Reserve will step in to provide emergency liquidity, (2) the FDIC will guarantee a bank’s short-term deposit liabilities, and (3) regulators may offer a bailout to make sure that a really large bank does not inflict serious economic damage through its failure. Because of these protections, bank shareholders should underprice the cost of their risk seeking. They will be slower to discount the value of their bank equity investment relative to other types of firms.\footnote{315}{See supra Part II.B.}

At first sight, asset managers, invested across multiple firms, may be particularly susceptible to these bad incentives. The scale of the gains on offer are vast. Blockholders are invested across many of the biggest U.S. financial firms that have system-wide access to cheap credit and the greatest likelihood of carrying the “too-big-to-fail” label.\footnote{316}{See supra Part II.B.}

Also, asset managers can push bank managers by providing a meaningful check on their power and influence. As blockholders with an enormous reserve of available capital, these asset managers represent especially persuasive voices to take bank managers down risk-chasing pathways.\footnote{317}{For further information on the powerful influence of blockholders, see Edmans & Holderness, supra note 15, discussing the finance literature surrounding the question of blockholder influence.} Viewed in this way, even though bank governance entails high expense, the pay-offs could be tantalizing for asset managers. For shareholders like BlackRock, Vanguard, and other blockholders across the banks studied, the cost-benefit trade-off might seem especially lucrative. Rather than seeking out changes at every single one of their banks, it may be possible to encourage changes across many or most banks by taking action at one or two large institutions. With the possibility of a more systemic impact across multiple
firms, risky activist governance may provide real bang for the buck.

Conversely, returning to the asset manager as the paradigmatic passive shareholder, rational passivity by asset managers can also constitute a source of riskiness in large banking institutions. Passive asset managers may fail to invest in properly overseeing a bank. If they miss signs of risky behavior by managers or do not punish it in a timely way, their passiveness can breed negative externalities across the system.\textsuperscript{318}

Passivity by investors like Fidelity and Vanguard can be risky where their apathy leads them to follow more aggressive, activist players seeking governance changes. As Professors Gilson and Gordon argue, activism in corporate life tends to follow the lead of activist hedge funds that seek a return on their money by suggesting changes to a target’s governance practices.\textsuperscript{319} Apathetic institutional investors can simply go along with these more engaged actors without having to privately expend efforts and capital.\textsuperscript{320} In banking, hedge fund activists can purchase a small stake in a bank and use this share to agitate for change—with asset managers motivated to simply go along with a vocal shareholder advocate. Trian Partners, for example—an activist—worked to change the governance of State Street and Bank of New York Mellon, large U.S. banks that specialize in the safekeeping of financial assets.\textsuperscript{321} Trian purchased a 1.2% share in State Street in 2011 (rising to 3.3% before being sold off in 2013) and a 2.5% stake in BNY Mellon in 2014 (worth $1.05 billion at the time of purchase).\textsuperscript{322} In the case of State Street, Trian published a forty-page list of State Street’s alleged problems and


\textsuperscript{319} Gilson & Gordon, supra note 35.

\textsuperscript{320} Id.


pushed for management to cut operating costs and increase revenue.\footnote{323} For example, one of Trian’s proposals suggested that State Street spin off its asset management arm—State Street Global Advisors—to take advantage of the revenue gains.\footnote{324} While this latter proposal fell by the wayside, State Street’s share price did climb and Trian sold at a profit in 2013.\footnote{325}

Controversy surrounds the question of whether hedge fund activists are a benefit or burden to corporate governance.\footnote{326} It is not the aim of this Article to take any position on this issue. The point is simply that activist advances in banks can implicate concerns of financial risk. For example, cost-cutting measures might involve shedding internal supervisory and compliance staff, increasing the workload on those left behind, or hiring less qualified individuals to fill the same positions. Indeed, Professor Roman’s study on shareholder activism in banking pointed to its potential to introduce riskiness into the financial system by creating pressure on management to produce higher shareholder returns—at a cost to the financial system as a whole.\footnote{327}

Passivity by asset managers, then, may fail to catch instances of potentially damaging activism. Where the interests of an activist may be focused on a single firm for a determined horizon of time, like that of BlackRock, Fidelity, or Vanguard, the effect is broader and extends across the system of banks as a whole. While an activist agenda may be beneficial at one bank, its pursuit may result in an increase of risk at others, placing the longer-term value of funds at risk of significant depletion.

State-Street [hereinafter Trian Partners]; cf. Chon, supra note 322.}
\footnote{324}{Trian Partners, supra note 323.}
-state-street-stakes-last-quarter.}
\footnote{326}{See, e.g., Brav et al., supra note 308; John C. Coffee, Jr. & Darius Palia, The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance, 1 ANNALS CORP. GOVERNANCE 1 (2016).}
\footnote{327}{Roman, supra note 307 (noting that the increased riskiness was not pronounced during a crisis—but rather ex ante in normal times).}
C. WHY SHAREHOLDERS CAN SUCCEED IN BANK GOVERNANCE

Asset managers can be beneficial for bank regulation. Their passivity, ironically, can offer a counter-point to the conventional view that bank shareholders are risk seeking and a danger to financial stability.

As discussed in Part II, asset managers have generally shown themselves to be passive in corporate governance. Because they manage money for others, earn flatter compensation through management fees (rather than a cut of the profits), and try to keep these fees low for customers, a passivity posture in governance seems unsurprising. Bank governance, especially, can harden this rational apathy. Information costs are high, and the availability of the safety net dissuades shareholders from governance and monitoring. Given that asset managers are invested at the biggest, most systemic of U.S. banks, both of these factors are likely to be especially salient.

But seen another way, this trend towards passivity also means that asset managers are less likely to be risk-seeking bank shareholders. Asset managers do not stand to take a cut of the profits from such risk-taking privately. Whatever gains they make from governance will also accrue to competitor asset managers. Blockholder asset managers, thus, present regulators with a presumptively safer shareholder than what theory might first suggest. Asset managers have only recently deepened the economic stakes within the banking sector, significantly increasing block stakes from 2011 onwards. How these shareholders actually behave over time will only become clearer. But, from the standpoint of their business model—as well a past record of passive governance—their presence within the equity of the financial system points to a more benign shareholder with the potential, if properly harnessed, to benefit regulation and financial stability. Certainly, as mentioned above, passivity can be risky if it means a free hand to managers or riskier shareholders to move the banks towards reckless risk-taking. Importantly, however, the fact that asset managers are not primarily driven towards aggressive outcomes offers regulators a less worrisome actor within financial markets.

Asset managers are also better placed than other types of shareholders to internalize the high costs of bank oversight. Particularly for those invested across multiple large banks, the costs

328. Gilson & Gordon, supra note 35.
of acquiring and analyzing information pertaining to bank balance sheets can be more efficiently borne than by other types of bank shareholders. Their investment in privately acquiring data about banks and banking can pay off by being applicable to the many firms where asset managers are invested. Blockholders like BlackRock, State Street, or Vanguard can utilize insights about the industry to their extensive portfolio of bank equity holdings.

Indeed, by being able to cast an industry-wide eye across the financial market, blockholders provide a partial private fix to the concern that capital regulation is not well tailored to deal with system-wide risks. As Professor Acharya observes, capital reserves at individual banks may be too shallow to match the hit of a system-wide cascade of problems.\footnote{Viral V. Acharya, \textit{A Theory of Systemic Risk and Design of Prudential Bank Regulation}, 5 J. FIN. STABILITY 224, 224–25 (2009).} Professor Scott points to the problem of market-wide interconnection between firms as an amplifying catalyst for the spread of contagion across financial markets.\footnote{Scott, supra note 4.} As the Crisis made clear, financial firms showed themselves vulnerable to correlated risk-taking (e.g., all investing in real estate referenced securities) that deepened the intensity of the crash as asset values fell simultaneously across balance sheets.\footnote{Indeed, this problem of correlated risk-taking in finance is discussed in detail by Vanguard. Christopher B. Philips et al., Vanguard, \textit{Dynamic Correlations: The Implications for Portfolio Construction} 3–5 (2012); see also Marko Kolanovic, J.P. Morgan, \textit{Rise of Cross-Asset Correlations: Asset Class Roadmap for Equity Investors} 7–9 (2011).} The current design of capital cushions takes some steps to deal with the problem of systemic risks, such as by imposing a special surcharge on the largest banks.\footnote{See PWC, supra note 129.} This additional layer of capital can give the biggest firms an extra buffer to protect against sudden cascades of destabilizing risk and to also stop large risks from bleeding out from the bank into the financial system.

Asset managers like BlackRock and Vanguard can offer a separate, more systemic lens to better analyze the risks accumulating within financial markets. As blockholders across nearly all the major banks, they possess information and clout to act in case these risks accumulate. Perhaps most importantly, funds administered by asset managers are anchored by a fiduciary duty owed to savers.\footnote{For discussion, see Gilson & Gordon, supra note 35.} To the extent that asset managers fail in
monitoring banks and allow crises to emerge, they risk seeing fund equity being used up to ensure the safety of the financial system. With their funds invested across multiple banks, asset managers face the doomsday prospect that bank runs within the financial system might deplete the value of any number of funds. This potential risk raises a strong business case, if not perhaps even a legal argument, for fund managers to invest in bank oversight as a way of forecasting and mitigating the risk to their funds within the financial system.

IV. POLICY EXTENSIONS AND IMPLICATIONS

This Article makes the following three contributions. First, it shows that the twenty-six most important U.S. banks have an increased number of blockholders in their capital structure since 2011. In the period following the implementation of the Dodd-Frank Act, some of these top banks have gone from having no equity blockholders to multiple such shareholders on their balance sheets. A small group of asset managers have come to dominate as shareholders of record in banking, representing the funds they administer. By becoming blockholders at the largest and most systemic U.S. banks, funds run by these asset managers have assumed the residual default risk of much of the financial system.

Second, this Article examines the effectiveness of asset managers as essential players in bank governance. As argued in Part III, the picture is mixed. As investors across multiple banks, asset managers face hurdles both informationally and practically in acquiring information about complex financial firms. It is also possible that these asset managers behave like a paradigmatic bank shareholder and use their power and presence to engage in widespread risk-taking. But, this Article provides a more nuanced account of their incentives. Importantly, asset managers have traditionally been passive players in governance. This may be beneficial for bank regulation to the extent it offsets risk seeking. They are also well placed to internalize high information costs efficiently to help further their oversight efforts.

In its third contribution, this Part proposes pathways to harness the strengths of asset managers as bank shareholders to motivate a more robust bank supervisory system. This outline represents a first step in a longer project to analyze the implications of how risk in the financial system is allocated and who bears it. The end goal is anchored in concerns of political economy to determine whether those contracting to bear the risks of
the financial system, in fact, possess the institutional resilience to do so.

A. A Duty to Supervise

Asset managers have considerable reason to exercise oversight of the financial system. They control funds that take on potentially large and also complex risks by owning block equity stakes at large and systemically significant banks. Banks are unique companies. Their core design implicates risk: short-term liabilities (liabilities) constitute a basis for funding longer-term assets (loans). If banks run into problems, a rush by depositors to retrieve their cash can result in banks having to liquidate loans and sell off their assets in panicked, fire-sale conditions. Because depositors may fail to distinguish between banks, a crisis at one can spiral into a wider systemic collapse. Such market-wide peril can have a particularly disastrous effect for asset managers who are invested widely in the financial system. As seen in the aftermath of the 2008 Crisis, financial failure may prompt savers to see their fund portfolios lose value as well as to cash out what they have saved with asset management firms.

From this standpoint, asset managers have a strong incentive to perform oversight of the banking system. Those who save with them ought to also support the exercise of such scrutiny. Indeed, regulators too possess real reasons to see asset managers perform more diligent oversight and governance systematically in financial markets. As argued earlier, asset managers, as bank shareholders, present a much more palatable proposition than theory’s hypothetical bank shareholder. Because of their historic passivity—they do not have their own money directly on the line or pay managers performance-based fees—asset managers, in particular, may be much less motivated to chase risks at the expense of financial stability. Perhaps most importantly, asset managers are invested system-wide, with the likes of BlackRock and Vanguard possessing block equity investments across almost all of the big twenty-six banks. This means that investments in information and analysis by asset managers should be well-spent. Further, because of their investment at multiple firms, asset managers should possess a systemic perspective when analyzing risk and exercising oversight. This can

334. RICKS, supra note 4; Diamond & Dybvig, supra note 71.
335. RICKS, supra note 4, at 113–22.
336. Cotter et al., supra note 191.
help reassure regulators. Rather than simply aligning themselves to short-term, risk-seeking bank managers at a single firm, asset managers may exercise a more systemic lens to dissuade a bank from taking risks (e.g., correlated exposures) that might imperil other firms within the financial system.

With asset managers embedded within the equity of the financial system, it seems timely to explore whether regulation will benefit from requiring asset managers to have an affirmative duty of diligent oversight. In other words, ought regulators require those asset managers holding a block (or sizable) stake at a bank to take on a more explicitly proactive role in monitoring the bank? Such a duty would require an asset manager to show that she has taken steps to more carefully monitor bank risk-taking and its system-wide impact, as well as show the steps and suggestions an asset manager has forwarded to improve governance outcomes at the bank.

If regulators do not wish to impose a full duty, they might still strongly encourage asset managers to diligently monitor bank risks. This softer, but still persuasive, nudge towards governance may work to bring asset managers into bank oversight without the full legal and administrative costs involved in creating a duty.

A requirement that asset managers oversee bank riskiness will have to adapt to the fiduciary duty they owe to fund holders to deliver returns. Higher transaction costs to perform governance, combined with reduced profits from a more cautious banking system, might perhaps constitute a breach by an asset manager of her duty to fund holders.337

But the requirement that asset managers do more to monitor banks should not face a serious challenge on this count. For one, an obligation on the part of asset managers to monitor banks does not require that shareholders stamp out all risk-taking (and thus all opportunities for a bank to make a profit) but, rather to scrutinize risk-taking more diligently for its impact on the bank’s solvency and that of the financial system. Indeed, an asset manager’s disapproval may fail to change a bank’s policy if other shareholders fail to go along or if they disagree with the asset manager’s assessment of riskiness. As noted in Part III, firms may reasonably differ about what a safe, well-functioning financial institution looks like and how it should operate as a matter of governance. In addition, scholars have long remarked

that the content of a fund manager’s fiduciary standard is notoriously fuzzy, giving rise to considerable uncertainty regarding how it should be interpreted. This interpretative untidiness gives room to create a stronger mandate on asset managers towards bank oversight. As scholars have recognized, the peculiar nature of bank capital structure has impacted how the law interprets (and should interpret) traditional duties to which corporate law actors like directors are subject. Particularly given that scrutiny by asset managers should protect fund interests from being diminished by bank recklessness, introducing a duty (or recommendation) for asset managers to monitor should be legally sound to challenge.

A number of scholars have offered solutions to enhance corporate governance at financial institutions. Professor Schwarcz, for example, has advocated for bank managers to observe a duty to the “public interest” in the performance of their duties. Professor Omarova suggests mandating that bank boards include a representative of the state to advocate on behalf of the public. Policy ideas such as these reflect the ongoing uneasiness of observers that corporate governance and financial regulation are intrinsically linked and that regulatory reform has not done enough to shore up this transmission channel for financial risk-taking.

This Article’s proposal also recognizes the connection between bank governance and financial stability. It is, however, shaped and motivated by the real-world emergence of asset managers as key shareholders taking on their books (or rather those of their funds) potentially enormous bank default risk. This proposal is grounded in the argument that asset managers should be safer bank shareholders, bringing a systemic lens to oversight.


340. Schwarcz, Public Interest, supra note 242; see also Min, supra note 242.

341. Omarova, supra note 243.

342. See also Hockett, supra note 243 (explaining and analyzing the limits of corporate law concepts in financial regulation).
as well as a deeper capacity to absorb and efficiently use research investments.

A proposal such as this, however, comes with drawbacks. First off, it runs counter to the business model and governance practices of asset managers. Imposing a mandate to supervise banks on asset managers—who are traditionally passive, reluctant to charge high fees, and unlikely to see competitive benefit from active governance—presents a practical challenge. For example, if asset managers must invest in information and action, they will presumably pass some or all of these costs on to customers. If savers must pay more to access long-term wealth management products, fewer might do so, depriving them of an important economic resource.

A mandate on asset managers to exercise active governance can thus backfire. At a time when banks need ready access to equity capital, governance costs may discourage asset managers from investing their fund capital into the bank equity. On the one hand, this might seem like a desirable outcome to the extent that reducing investment by asset managers in banking might lessen the default risk falling on fund holders. On the other, however, it might also give rise to problematic outcomes. If asset managers pull back from the banking system, other capital providers will take their place. This might include funds that risk their own money, take bigger risks, and that become susceptible to the perverse incentives that usually afflict bank shareholders. Where bank shareholders end up being more risk seeking, their influence on the financial system may still place public savings at risk if the market falters or taxpayers are forced to provide a bailout to a failing system.

Second, there is no guarantee that asset managers will exercise good governance. Where suggestions are poorly thought out, asset managers may propagate bad ideas and compound risks within the system as a whole. For instance, they might offer similar proposals for different banks. This may be problematic as large banks do differ from one another and one-size-fits-all solutions may cause more harm than good. For example, Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo are far bigger by asset size than other banks on the Federal Reserve’s list. JPMorgan Chase tops this list with more than $2 trillion in assets, with Wells Fargo and Bank of America coming
in next with around $1.7 trillion in assets each.\textsuperscript{343} Arguably, decisions taken with respect to these banking giants may have a different effect on the financial system than, say, a similar proposal at a smaller, but still significant bank, like PNC Bank (asset size, approximately, $350 billion).\textsuperscript{344} A bad set of governance proposals that hit the likes of JPMorgan Chase will cause heavy stress on the financial system. However, a bigger bank will also be able to access the fullest array of state resources for assistance. Even without relying on state support, the biggest banks may perhaps be better able to withstand periodic hits, by dint of diversification, a deeper capital base (e.g., because of a higher G-SIB capital surcharge), and access to international credit markets. In sum, asset managers may underestimate or misunderstand the fuller impact of their decision making, a foreseeable outcome given the information asymmetries and complexities that are inherent to modern banking.

Third, policy initiatives to lower the governance costs on asset managers are likely to be practically unworkable. To make it easier and cheaper for asset managers to comply with the duty, policymakers might try to help them defray these costs. For example, regulators might consider giving asset managers better access to information about bank performance. Richer information should yield more accurate assessments about bank risk and the degree of default exposure that fund holders are assuming. Because of the public interest in ensuring that the wealth of savers is safe, taking measures to lower the compliance costs for asset managers may seem like a prudent idea. But interventions along this line of reasoning are riddled with problems. Asset managers might be nudged towards activism through the offer of cheaper information (for example). However, by getting special regulatory assistance, asset managers enjoy extra (maybe unfair) advantages relative to other types of shareholders. By giving privileges to asset managers over other investors, regulators are putting their thumb on the scale in favoring one type of investment vehicle over another. Special access to information and assistance can also lead to the exact result regulators wish to avoid. With information, asset managers might consider banks too risky or too complex. They might sell their stake instead of investing in corporate governance actions.\textsuperscript{345} Such exits

\textsuperscript{343} Statistical Release 2018, supra note 274.
\textsuperscript{344} Id.
\textsuperscript{345} However, asset manager blockholders who wish to sell their stakes do face economic constraints. See Patrick Juhnke, Voice Versus Exit: The Causes
will send a powerfully negative signal to the market, potentially setting off panic about a bank’s health. Conversely, cheap access to important information about critical institutions might prompt fund managers to overinvest in banking stocks, even if these present serious risks.

Finally, encouraging asset managers to exercise governance is likely to create serious concerns from the perspective of antitrust policy. Already, scholars have voiced deep misgivings about the broad block ownership by asset managers of public companies, arguing that it leads to collusive, anticompetitive conduct.346 They posit that, with the same set of asset managers holding stakes at competitor firms, U.S. public companies are more likely to engage in, or at least tolerate, anticompetitive behavior. In the airline industry as well as in banking, they point to a record of higher prices and reduced choice for consumers.347 This account remains contentious. However, its resonance will be amplified by financial regulatory policies seeking to encourage asset managers to use their block shareholder power to push governance outcomes at rival bank firms. This Article’s concern lies squarely in the field of financial regulation and is motivated by the objective of harnessing the strengths of asset managers to build market solvency and protect the interests of fund holders. However, it is clear that policymakers will inevitably face regulatory choices that stand in tension and that require authorities to carefully scrutinize the conduct of private actors in public markets.

Importantly, creating a duty for asset managers to privately scrutinize the banks they invest in does not absolve public regulators from strenuously supervising markets or dealing with policy questions (e.g., resolving tension between financial regulation versus antitrust law). This Article’s goal is to highlight the key place of asset managers on the front line of financial risk management in markets. With extensive broad block investment across the major U.S. banks, asset managers can offer a systemic lens to bolster, rather than replace or undermine, existing public oversight. Within this taxonomy, public regulators remain responsible for maintaining the safety and soundness of banking

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346. See AZAR, ULTIMATE OWNERSHIP, supra note 36; Azar, Anticompetitive Effects, supra note 36; Elhuage, supra note 36.
347. See supra notes 36, 76 and accompanying text.
markets—as well as the conduct of major asset managers as some of the largest shareholders within it.

B. QUESTIONS FOR FUTURE RESEARCH

This Article constitutes the first step in a longer project examining questions about how regulation allocates default risk in financial markets and whether those who hold it possess the institutional resilience to do so. This work begins by identifying which actors are emerging as the key absorbers of default risk in post-Crisis financial markets. Following the Dodd-Frank Act, regulation is clear in requiring the largest U.S. banks to deepen their capital base and to ensure that they are more fully funded by issuing common equity. Whether because of this policy focus or due to some other reason (e.g., increasing inflows of capital to mutual funds), bank capital bases now include multiple asset managers as blockholders. In examining the question of who holds this risk, then, this Article shows that it is being assumed by the largest asset managers, and ultimately those savers who entrust them with looking after their long-term wealth. In this work, I examined how effectively asset managers might behave as block shareholders to deploy their governance power to manage bank solvency.

This inquiry gives rise to deeper institutional questions about the capacity of asset managers (and the funds they control) to bear the default risk for much of the financial system. Put simply, what might happen to BlackRock or Vanguard—and their funds—if the financial system were to see a widespread run on the biggest U.S. banks? Are these shareholders too-big-to-fail? If regulators decided that one or more major U.S. banks should be wound down and for bank equity to be wiped out in order to pay off creditors, what kind of losses might savers suffer? How might an asset manager respond to prevent a sudden run on their funds in response to an imminent banking crisis—and will such steps be effective to staunch the bleeding within its own firm and also the financial system?

These questions constitute the subject of further research and scholarship. Its scope is not restricted to examining just the equity holdings of the biggest and most systemic U.S. banks. It extends more broadly to also analyze those securities whose payouts rank low on the priority ladder, explicitly designed to be consumed by a wind down procedure.348

348. For example, in the United States, designated large banks must have
Ultimately, this line of research aims to probe the limits of financial regulation and political economy. Regulation might set the rules by which banks are designed to be wound down, placing the risk of their failure on a certain cohort of actors. However, how those laws are implemented—if, indeed they are implemented at all—implicates issues of policy and political will. While Banco Popular might have been allowed to fail, with equity holders left to absorb the cost, other examples are less encouraging (such as Monte dei Paschi).\textsuperscript{349}

This example serves to highlight the significance of understanding more precisely and concretely the identity of those who ultimately support the default risk of large banks. While law seeks to build firewalls between too-big-to-fail firms and the real economy, whether these buffers hold up ultimately depends on who carries the burden. Understanding this interaction between financial regulation and politics can better reveal whether the laws on the books are really fit for purpose in practice.

**CONCLUSION**

This Article explores a tension in financial markets regulation: as policy emphasizes shareholder equity as necessary to bank safety, the suppliers of this equity comprise a small cohort of asset managers, investing Main Street’s savings. With wealth potentially exposed to the risks of large-scale financial failure, this Article explores the implications for bank corporate governance. It surveys how policy might harness the strengths of asset managers to be good stewards of their fund capital in financial regulation. In so doing, it sets the stage for exploring the fuller implications of capital regulation to more accurately determine how default risk is allocated in financial markets and who is charged with bearing it. In presenting this inquiry, this Article lays out a pathway to interrogate whether the laws on the books fit their implementation in practice, or whether policy has inadvertently encouraged the creation of too-big-to-fail shareholders in financial markets.

\textsuperscript{349} See supra notes 1–9 and accompanying text.